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# LIMITED LIABILITY FOR CORPORATE SHAREHOLDERS: MYTH OR MATTER-OF-FACT\*

BY RUTHEFORD B. CAMPBELL\*\*

## I. INTRODUCTION

One of the most important and firmly entrenched concepts of modern corporate law is the concept of limited liability.<sup>1</sup> The digests abound with ringing phrases granting the owners of corporations immunity from liability beyond their initial investment.<sup>2</sup> There are, however, numerous cases in which the courts have denied the owners of corporations the protection of limited liability and have held the owners liable for an obligation incurred by the corporation. It is the purpose of this paper to examine the theories under which the owners of corporations have been held liable for the contractual obligation of corporations.

## II. HISTORICAL DEVELOPMENT OF LIMITED LIABILITY

In their classic work, Pollock & Maitland stated that "[e]very system of law that has attained a certain degree of maturity seems compelled by the ever-increasing complexity of human affairs to create persons who are not men . . . and to regulate their rights and duties."<sup>3</sup> This "created person", or corporation, appears to have had its genesis in the Roman

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<sup>1</sup> See, e.g., N. BUTLER, WHY SHOULD WE CHANGE OUR FORM OF GOVERNMENT? 82 (1912) where he states: "I weigh my words when I say that in my judgment the limited liability corporation is the greatest single discovery of modern times. . . . Even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative unimportance without it."

<sup>2</sup> E.g., *Renault, Inc. v. Marble*, 317 F.2d 265 (10th Cir. 1963); *Adelstein v. Jefferson Bank & Trust Co.*, 377 S.W.2d 247 (Mo. 1964).

<sup>3</sup> 1 F. POLLOCK & F. MAITLAND, THE HISTORY OF ENGLISH LAW 486 (2d ed. 1968).

Empire.<sup>4</sup> The Roman "corporations" had many of the characteristics of modern corporations, including the right to sue and be sued in a common name, the right to hold property in the common name and the power to adopt by-laws.<sup>5</sup> The existence of limited liability, however, seems less clear. Although Professor Berle concluded that the Roman corporation "apparently achieved limited liability",<sup>6</sup> there has been as much scholarly support for the opposite position. Oscar and Mary F. Handlin have written that "there was no clear precedent from Roman law [for limited liability] . . .".<sup>7</sup> They dismissed opinion to the contrary as merely a misinterpretation of the distinction between individual and corporate obligations.<sup>8</sup>

It is also unclear whether early English corporate law afforded the owners of a corporation limited liability.<sup>9</sup> The best evidence available, however, indicates that the concept of limited liability was not an inherent characteristic of the 17th century English corporation.<sup>10</sup> Blackstone, in enumerating "powers . . . necessarily and inseparably incident to every corporation", did not list limited liability as a characteristic.<sup>11</sup> Other scholars, jurists, and commentators also omitted the

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<sup>4</sup> See, e.g., C. ABBOTT, *RISE OF THE BUSINESS CORPORATION* 20 (1936); W. BLACKSTONE, *COMMENTARIES OF THE LAWS OF ENGLAND* 498 (Chitty ed. 1832).

<sup>5</sup> A. BERLE, *STUDIES IN THE LAW OF CORPORATE FINANCE* 3 (1928). Berle also made the interesting observation that the Roman corporations, at least initially, were not created by the state and the state had nothing to do with them. Later, however, during the time of the late pagan emperors, fear of a plot against the throne resulted in a licensing requirement for the corporation. *Id.* at 3. See also J. GOEBEL, *CASES AND MATERIALS ON THE DEVELOPMENT OF LEGAL INSTITUTIONS* 536-51 (1937); Timberg, *Corporate Fictions*, 46 COLUM. L. REV. 533, 554 (1946).

<sup>6</sup> *Id.*

<sup>7</sup> Handlin & Handlin, *Origins of the American Business Corporation*, 5 J. OF ECON. HISTORY 10 (1945).

<sup>8</sup> *Id.* at n.52. See also Williston, *History of Business Corporations Before 1800*, 2 HARV. L. REV. 105, 160 (1888) wherein he stated that "in the Roman law it seems that if the corporation became insolvent the persons constituting it were obliged to contribute their private fortunes. . . ."

<sup>9</sup> It is interesting to note that there is little evidence that the development of corporate law in England was influenced by the Roman experience. See W. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION* 2 (1970).

<sup>10</sup> See, e.g., Williston, *supra* note 8, at 160-61.

<sup>11</sup> W. BLACKSTONE, *supra* note 5, at 475-76. The characteristics that are listed include: "1. To have perpetual succession . . . 2. To sue or be sued. . . 3. To purchase lands, and hold them. . . 4. To have a common seal. . . 5. To make by-laws or private statutes for the better government of the corporation. . . ." *Id.* at 476.

mention of limited liability when describing the characteristics of corporations.<sup>12</sup> It seems that Professor Williston was accurate when he stated:

[T]hough it may be hazardous to assert that at common law the rule was [that] if the corporation became insolvent the persons constituting it were obliged to contribute their private fortunes . . . , it is certain that, so far as the evidence goes, it points to that conclusion.<sup>13</sup>

The 1691 case of *Dr. Salmon v. Hamborough Company*<sup>14</sup> supports the contention that early English corporate law afforded owners no limited liability. There the court held that if a corporation was unable to pay its debts, a corporate creditor could force the corporation to levy an assessment against its members in order to obtain the necessary funds to pay the debt.<sup>15</sup>

Even as late as the early 19th century it is unclear whether an owner of corporate shares enjoyed limited liability. After an examination of the law of the period, the Handlins concluded that the results "strike at the very roots of the common assumption that limited liability was always an essential attribute of corporateness . . . , without specific statement in the charter."<sup>16</sup> Further, some legislatures had enacted laws explicitly making the shareholder of certain types of corporations liable for the debts of the company.<sup>17</sup> By 1888, however, Profes-

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<sup>12</sup> Handlin & Handlin, *supra* note 7, at 11 list others who omitted mention of limited liability as a characteristic of incorporation. See also Eaton, *The First Book in English on the Law of Incorporation*, 12 YALE L.J. 259, 281 (1903).

<sup>13</sup> Williston, *supra* note 8, at 160.

<sup>14</sup> 22 Eng. Rep. 763 (Ch. 1671).

<sup>15</sup> *Id.* But see E. DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 369 (1954) where he concludes that the holding of the *Dr. Salmon* case was not determinative of any indirect liability of shareholders for the debts of the corporation. The latter would result only if "corporations had broad power to make assessments and to enforce payment by action and not merely by forfeiture of a delinquent's shares. The question . . . was never judicially answered . . ." *Id.* at 369.

<sup>16</sup> Handlin & Handlin, *supra* note 7, at 10. See also Livermore, *Unlimited Liability in Early American Corporations*, 43 J. POL. ECON. 674 (1935).

<sup>17</sup> See Dodd, *The Evolution of Limited Liability in American Industry: Massachusetts*, 61 HARV. L. REV. 1351 (1948); Livermore, *supra* note 16. Both writers discuss the statutorily imposed unlimited liability on the shareholders of manufacturing corporations during the first half of the 19th century.

The Handlins used the passage of these types of acts as rebuttal to those who believed that limited liability was usual. The Handlins noted that the passage of the

sor Williston could assuredly assert that "it has been settled for a long time that individual members are not liable for the debts of a corporation . . . ."<sup>18</sup>

Although it is difficult to determine all the reasons for the shift to limited liability, the encouragement and retention of business enterprises by the states seem to have been the most pervasive factors. In Massachusetts, for example, which in 1809 had adopted unlimited liability for shareholders of manufacturing corporations,<sup>19</sup> the argument most consistently raised by the advocates of limited liability was based on the need to retain investment capital in the state.<sup>20</sup> It was argued that in order to make Massachusetts competitive with other states for the manufacturing companies and the benefits which accompany them, it must grant limited liability. Otherwise, the argument continued, the flight of capital to other states that did grant limited liability would be detrimental to the economy of the state.

Another argument raised in favor of limited liability was that it would be unfair to hold one shareholder liable for the debts of the entire corporation. This argument was stated in 1829 by a writer in *American Jurist*:

A person purchasing a single share of one hundred dollars in a corporation may be compelled to pay debts of the corporation to the amount of a hundred thousand, the whole business of the concern being managed without any interference with, or even knowledge of it on his part . . . . He may thus be made liable to an indefinite extent for the acts of others over whom he has no control. His risk is altogether disproportionate to his chance of profit.<sup>21</sup>

Finally, a Kentucky case decided in 1893 further illus-

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Law of March 3, 1809 (Mass. Stat. 1808, ch. 65, sect. 6), which gave unlimited liability for the shareholders of manufacturing corporations, was not met by "one word of the debate that would inevitably have followed a radical change." This, they contended, lent support to their thesis that in the absence of any charter provision, unlimited liability was normal. Handlin & Handlin, *supra* note 7, at 16.

<sup>18</sup> Williston, *supra* note 8, at 162.

<sup>19</sup> Stat. 1808, ch. 65, sect. 6 (1809).

<sup>20</sup> See DODD, *supra* note 15, at 1366-79. Dodd questioned whether limited liability had any impact on the location of manufacturing. He pointed out that other factors (e.g., abundant water) may have attracted capital to New Hampshire.

<sup>21</sup> 2 AM. JURIST 92, 101 (1829).

trates some of the considerations behind the transition to limited liability. In explaining the reason the Kentucky legislature had permitted two or more persons to form a corporation the Court stated:

[t]he purpose of the statute was to enable two or more persons possessed of a capital or skill to associate themselves in business, and to limit their liability as against the improvident acts of each other, or the act of the corporation . . . . It invites the investment of the capital stock of one to be placed in the same business with the skill of another, or a combination of capital that encourages trade, the burden of which mere individual enterprise would be unwilling to assume . . . .<sup>22</sup>

### III. LIABILITY OF SHAREHOLDERS BASED ON AGENCY PRINCIPLES

But in most of the cases the language about agency is merely a by-product of new law in the making — harmless until someone begins to take it seriously.<sup>23</sup>

Cases sometimes refer loosely to a corporation as being an agent for its shareholders.<sup>24</sup> Clearly, if a corporation is in an actual agency relationship with its shareholders, the shareholders would incur personal liability under *all* contracts executed on their behalf by the corporation. The existence of a true principal-agent relationship, however, is often difficult to show. Most often the court merely intones the magical word “agency” without analyzing the actual relationship.

It would be more logically consistent, and more legally correct, if the courts would apply the same reasoning and principles of agency law to corporate-shareholder relationships as it applies to other principal-agent situations. In order for the corporation to bind a shareholder as its “principal”, there must be found some “authority” for it to do so. This authority can be either “real” or “apparent,” but it must, nevertheless, exist.

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<sup>22</sup> Louisville Banking Co. v. Eisenman, 21 S.W. 531, 532 (Ky. 1893).

<sup>23</sup> E. LATTY, SUBSIDIARIES AND AFFILIATE CORPORATIONS 165 (1936).

<sup>24</sup> E.g., Wade & Wade v. Central Broadcasting Co., 288 N.W. 441, 443 (Iowa 1939); Platt v. Brander Co., 230 P. 633, 635 (Wash. 1924). See also P. POWELL, PARENT AND SUBSIDIARY CORPORATIONS § 21 (1931) (“In many cases, doubtlessly, the term ‘agent’ is used merely as equivalent to ‘instrumentality’ in the statement of the Instrumentality Rule.” *Id.*).

If the agency relationship is to be based upon "real authority", the principal (in this instance the shareholder) must manifest "to another person, called an agent, his willingness that the agent act on his behalf in some specified way in some specific transaction."<sup>25</sup> This manifestation might either be in words, or by the principal's conduct. If the former, the real authority is "express"; if the latter, it is "implied".

Express authority arises when "the principal in express and explicit language [makes] . . . clear to the agent his willingness or desire that the act in question be done."<sup>26</sup> Contrasted with this is implied authority that arises without explicit authorizing language.<sup>27</sup> But nonetheless the authority is given, either by failing to withhold the authority in a broad grant (in which "the agent is said to have implied authority to do acts consistent with the direction")<sup>28</sup> or by conduct by the principal that expresses to the agent the principal's desire for the agent to act.<sup>29</sup> In addition to express and implied authority, the power of an agent to bind his principal can be based on "apparent authority".<sup>30</sup> Contrary to real authority, where the manifestations by the principal to the agent are all-important, apparent authority is based on manifestations made by the principal to a third party. Accordingly, if the principal's language in a course of conduct leads a third party to reasonably believe that the agent has authority to bind the principal, that agent has apparent authority. This is true notwithstanding that the agent has no real authority.

While many cases hold that a shareholder is liable for the debts of his corporation if the corporation is his agent, an analysis of the cases according to agency principles indicates that

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<sup>25</sup> F. MECHEM, *OUTLINES OF THE LAW OF AGENCY* § 35 (4th ed. 1952).

<sup>26</sup> *Id.* at § 40.

<sup>27</sup> See F. MECHEM, *supra* note 25, at §§ 51-54; W. SEAVEY, *STUDIES IN AGENCY* 81 (1949).

<sup>28</sup> W. SEAVEY, *supra* note 27, at § 8.

<sup>29</sup> F. MECHEM, *supra* note 25, at § 54.

<sup>30</sup> RESTATEMENT (SECOND) OF AGENCY § 8 (1959). The theoretical basis for the apparent authority notion has been the source of debate for commentators. Some see it as an estoppel concept, while others view the concept as based on contract. W. SEAVEY, *supra* note 27, at 81-82. Mechem, however, thinks that the debate over the theory is "unfortunate", as it is "scarcely more than a difference in terminology." F. MECHEM, *supra* note 25, at § 90.

<sup>31</sup> See RESTATEMENT (SECOND) OF AGENCY § 8, comment a (1959).

often no true agency relationship exists. Rather, the courts are, in actuality, finding liability based upon a related theory, the "instrumentality theory."<sup>32</sup> As one authority has stated: "In many cases, doubtless, the term 'agent' is used merely as equivalent to 'instrumentality' in the statement of the Instrumentality Rule."<sup>33</sup>

In other instances, however, courts have utilized traditional principal-agent concepts to hold the owners liable on corporate obligations. Although the courts are often unclear in their analyses, the cases typically involve an allegation that the corporation had real authority, usually implied, to act as agent for the owners.

One such case is *Morgan v. Jackson Ready-Mix Concrete*,<sup>34</sup> in which the plaintiff, in order to secure payment for concrete sand delivery to Hyde Construction Company, brought suit against its owners, Morgan and Hyde. The plaintiff alleged that the Hyde Construction Company was the agent of Morgan and Hyde, who, incidentally, were also partners in a general contracting firm. After stating the rule that a corporation may act as an agent for a natural person or for another corporation, the court upheld a jury verdict in favor of the plaintiff. The court determined that the corporation was an agent for the partners, apparently because Morgan and Hyde owned and completely dominated Hyde Construction Company, and utilized it to carry on their business as general contractors. The court emphasized that the partnership agreement between Morgan and Hyde contained a provision stating that "all bids for work shall be made in the name of R.W. Hyde, Jr., doing business as Hyde Construction Company. . . ."<sup>35</sup>

In *Darling Stores Corporation v. Young Realty Co.*<sup>36</sup> an

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<sup>32</sup> E.g., *Ohio Edison Coal v. Warner Coal Corp.*, 72 N.E.2d 487 (Ohio 1945); *Tennessee Consol. Coal Co. v. Home Ice & Coal Co.*, 156 S.W.2d 454 (Tenn. 1941). For a discussion of the instrumentality theory, see the discussion *infra* at § IV.

<sup>33</sup> P. POWELL, *PARENT AND SUBSIDIARY CORPORATIONS* § 21 (1931). See also *New York Trust Co. v. Carpenter*, 250 F. 668, 673 (6th Cir. 1918) where the court recognized that the district court had used "'agency' as a synonym of 'adjunct,' whatever that may mean and as descriptive of a relation variously defined in the case as 'adjunct,' 'branch,' 'instrumentality.'" *Id.* at 673.

<sup>34</sup> 157 So. 2d 772 (Miss. 1963).

<sup>35</sup> *Id.* at 774.

<sup>36</sup> 121 F.2d 112 (8th Cir. 1941). Although this case was apparently decided on agency principles, the court's analysis often was confused as to the actual theory



agent-principal relationship again was found to exist between a corporation and its owner. In that case, Darling Shops, Inc. (Shops), a subsidiary of Darling Stores Corporation (Stores), became assignee of a lease of property, which was owned by Young Realty Company. Shops, which apparently had no assets or income of any kind, was "created and existed solely for the purpose of leasing store locations throughout the United States which they in turn subleased to the [parent, Stores]."<sup>37</sup> The property leased from Young was utilized by the parent for its operation of a retail store. When the lease was abandoned, Young sued Stores, the parent of the contracting party. In the course of holding the parent liable on the lease, the court found that an agency relationship did exist, saying "as we have shown, however, the agency here did in fact exist, merely carrying forward the relationship with an undisclosed principal."<sup>38</sup>

The imprecise analyses in the foregoing cases are typical in this area. One problem caused by this is uncertainty as to the type of authority possessed by the corporation. Although the issue usually centers on whether the corporation has real authority to bind the owners to a third party, this rather fundamental part of the analysis is often omitted. Perhaps because of this, the courts refer only vaguely, if at all, to which actions of the owners have established the principal-agent relationship.

To establish real authority under agency concepts, the principal must use words or engage in conduct that "causes the agent to believe that the principal desires him *so to act on the principal's account*."<sup>39</sup> This requirement causes some obvious conceptual problems. Primarily the question arises of how a

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utilized. At one point the court used the term "alter ego" (*Id.* at 115); at another point the court stated it would "ignore the fiction of corporate legal entity when the circumstances justify it . . . ." *Id.* at 116. In the end, however, it appears the case was decided on agency principles, as the court stated that "the agency here did in fact exist . . . ." *Id.* at 117.

<sup>37</sup> *Id.* at 113.

<sup>38</sup> *Id.* at 117. Examples of the cases which have discussed agency as a basis for liability between the related business entities include *Pacific Can Co. v. Hewes*, 95 F.2d 42 (9th Cir. 1938); *National Plumbing Supply Co. v. Torretti*, 175 S.W.2d 947 (Mo. 1934); *Whitehurst v. FCX Fruit & Vegetable Serv., Inc.*, 32 S.E.2d 34 (N.C. 1944).

<sup>39</sup> RESTATEMENT (SECOND) OF AGENCY § 26 (1957) [emphasis added]; *W. Seavey*, *supra* note 27, at § 18.

shareholder, who may be in complete control of a corporation, manifests to the corporation a desire that the corporation act on his behalf.<sup>40</sup>

If a shareholder of a corporation goes to the president of the corporation and instructs the corporation to represent him in a certain matter, quite clearly there is express authority for the corporation to act on the shareholder's behalf. The more typical cases, however, exemplified by *Morgan* and *Darling Stores*, involve less explicit authorization. But even in these cases there existed factual circumstances that could support a contention that the corporations had *real* authority to act for the owners. The key factors in those cases seem to be the complete dominance of the agent-corporation by the owner and the fact that the contracts were in furtherance of the business purpose of the owners. Since the establishment of real authority requires the principal to manifest to the agent the principal's "willingness that the agent act on his behalf in some specified way in some specified transaction,"<sup>41</sup> it is reasonable to presume such a manifestation from the facts that the owners completely dominate the corporation and that the contracted-for benefits further the separate business purpose of the owners.

An unquestioning acceptance of this notion, however, may lead to substantial damage to the concept of limited liability. For example, how does one distinguish the *Darling* case and the *Morgan* case from any situation in which one person or a group of persons dominate a corporation. If, as the above cases seem to indicate, authority to bind the principal can spring from control plus receipt of the benefits of the transaction, could not one say that a corporation is always the agent for one in a controlling position with respect to that corporation?

In his work, *Parent and Subsidiary Corporations*, Professor Powell perceived the same problem.<sup>42</sup> After posing a hypothetical situation strikingly similar to the *Darling* and *Morgan* cases, Powell stated that:

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<sup>40</sup> As Professor Seavey has stated: "If Corporation A by written contract expressly makes Corporation B its Agent, the former is liable for the latter's obligations (incurred within the scope of the agency) on the ordinary principles of the law of Agency." W. SEAVEY, *supra* note 27, at § 10. See also, E. LATTY, *supra* note 23, at § 43.

<sup>41</sup> F. MECHEM, *supra* note 25, at § 35.

<sup>42</sup> POWELL, *supra* note 33, at §§ 21 & 22.

on ordinary principles of agency [the parent corporation] would be [liable]. As a practical matter we must admit that the parent corporation completely dominates the subsidiary, and that from a practical standpoint, the subsidiary's business is run in the interest of the parent corporation.<sup>43</sup>

Powell's solution in this situation is simple: He rejects agency concepts, stating that they are inappropriate for holding the shareholders liable, unless there exists express authority in the corporation to act on behalf of its owners. He fears that "a sincere application of agency rules would largely destroy the protection afforded stockholders by incorporation."<sup>44</sup>

In Kentucky, there are only a handful of cases in which the court discusses the impact of agency concepts on the limited liability of corporate owners. Furthermore, the value of these cases is minimal, because they either contain a confused discussion of the issue,<sup>45</sup> involve an issue significantly different from the issue herein under discussion,<sup>46</sup> or apply the law of another jurisdiction.<sup>47</sup> Accordingly, it is impossible to predict how Kentucky courts would treat a claim that a corporation was an agent for its owners. The Kentucky cases do seem to recognize that a principal-agent relationship can exist between the corporate owner and the corporation,<sup>48</sup> but it is not clear what a plaintiff would have to show to establish that the corporation had the necessary authority to contractually bind the owners to third parties. Nevertheless, if an owner of a corporation completely dominates the corporation and if the corpora-

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<sup>43</sup> *Id.* at § 22.

<sup>44</sup> *Id.*

<sup>45</sup> *Richmond & Irvine Constr. Co. v. Richmond, Nicholasville, Irvine & Beattyville R.R.*, 68 F. 105 (6th Cir. 1895); *Harlan Pub. Serv. Co. v. Eastern Constr. Co.*, 71 S.W.2d 24 (Ky. 1934).

<sup>46</sup> *Ayer & Lord Tie Co. v. Commonwealth*, 82 S.W. 177 (Ky. 1925).

<sup>47</sup> *In re Kentucky Wagon Mfg. Co.*, 3 F. Supp. 958 (W.D. Ky. 1932). This case contains a lengthy discussion of how the elements of a principal-agent relationship between related corporations affect the liability of the controlling corporation. The case, however, involved the question of whether a claim of a controlling corporation against a bankrupt subsidiary corporation should be subordinated to other claimants. Where the issue is one of subordination in bankruptcy, the courts do not apply state law. See 3A W. COLLIER, *BANKRUPTCY* ¶ 63.03 n.29 and ¶ 63.08 n.1 (14th ed. 1972). Therefore, that case does not necessarily involve a discussion of Kentucky law.

<sup>48</sup> *Richmond & Irvine Constr. Co. v. Richmond, Nicholasville, Irvine & Beattyville R.R.*, 68 F. 105 (6th Cir. 1895); *Harlan Pub. Serv. Co. v. Eastern Constr. Co.*, 71 S.W.2d 24 (Ky. 1934).

tion is utilized by the owner in the running of a personal business, there is significant risk that the corporation will be declared the agent of the owner. This risk would be present whether the owner were an individual or a corporation.<sup>49</sup>

#### IV. DISREGARD OF THE CORPORATE ENTITY

##### A. *Traditional Theories*

In addition to the agency theory, plaintiffs have utilized several other approaches in an effort to hold the owners of a corporation liable for corporate obligations. One such approach, the *instrumentality* theory, was expounded by Professor Powell nearly forty years ago.<sup>50</sup> Powell suggested that the disregard of the corporate entity required the establishment of three elements: (1) the corporation was a mere instrumentality of the shareholder; (2) the shareholder exercised control over the corporation in such a way as to defraud or harm the plaintiff; (3) refusal to disregard the corporate entity would subject the plaintiff to unjust loss.<sup>51</sup>

Powell's formulation has been relied on in a number of cases.<sup>52</sup> Furthermore, the courts that have adopted Powell's test have been somewhat rigid in requiring that all elements be present.<sup>53</sup> Accordingly, in *Lowendahl v. Baltimore & O.R.R.*,<sup>54</sup> a case decided under the instrumentality theory, the court refused to pierce the corporate veil and hold the parent corporation liable. This was apparently because the parent had not

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<sup>49</sup> But see Hamilton, *The Corporate Entity*, 49 Tex. L. Rev. 979 (1971) ("courts are probably more willing to 'pierce the corporate veil' when the defendant is a corporation rather than an individual.")

<sup>50</sup> P. POWELL, PARENT AND SUBSIDIARY CORPORATIONS (1931).

<sup>51</sup> *Id.* at 4-6. One court stated the requirements of the instrumentality theory as follows: "there must be complete domination as to the transaction in question, fraud or injustice must result from the use of such control, and the plaintiff's injury must be the proximate result of the control and breach of duty of the dominating corporation." *National Bond Fin. Co. v. General Motors Corp.*, 238 F. Supp. 248, 255 (W.D. Mo. 1964).

<sup>52</sup> *E.g.*, *Fish v. East*, 114 F.2d 177 (10th Cir. 1940); *Brown v. Margrande Compania Naviera*, 281 F. Supp. 1004 (E.D. Va. 1968).

<sup>53</sup> In some cases utilizing the instrumentality theory, the basis for the refusal to disregard the corporate entity is less than clear. *E.g.*, *National Bond Fin. Co. v. General Motors Corp.*, 238 F. Supp. 248 (W.D. Mo. 1964).

<sup>54</sup> 287 N.Y.S. 62 (App. Div. 1936), *aff'd*, 6 N.E.2d 56 (1936), *rehearing denied*, 7 N.E.2d 704 (1937).

exercised the degree of control required under the instrumentality theory. The court found, instead, that control of the subsidiary corporation had been in the hands of one Walter Van Bokkelen, who had been a substantial stockholder and president of the subsidiary. In the course of the opinion the court defined the extent of dominance necessary to hold a shareholder liable under the instrumentality theory:

Control through mere ownership of a majority or of even all the capital stock and the use of the power incident thereto to elect officers and directors will not in and of itself predict liability. [Citation omitted.] Liability must depend upon a domination and control so complete that the corporation may be said to have no will, mind or existence of its own, and to be operated as a mere department of the business of the stockholder.<sup>55</sup>

In addition to the requirement of control, disregarding the corporate entity under the instrumentality theory requires an element of unfairness.<sup>56</sup> An illustration of this is *Brown v. Margrande Companie Naviera, S.A.*<sup>57</sup> In that case the plaintiff had rendered salvage service to a tanker that was owned by Texas Panama Company (Panama). The tanker was carrying cargo owned by Texas Export Company (Export). Texaco, Incorporated (Texaco) owned stock in both companies and placed some of its directors on the boards of each company. Although there was little evidence of domination beyond the above facts,<sup>58</sup> the court made clear that even if there had been domination, Texaco would not have been liable for the salvage service. In explaining this conclusion, the court stated that "[s]omething more [than control] is needed, such as fraud, illegality, or wrongdoing which produced the injury or complaint, otherwise the corporate entity will stand." Then, having

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<sup>55</sup> *Id.* at 72-73.

<sup>56</sup> See, e.g., *State v. Swift & Co.*, 187 S.W.2d 127 (Tex. 1945); *Beale v. Kappa Alpha Order*, 64 S.E.2d 789 (Va. 1951).

<sup>57</sup> 281 F. Supp. 1004 (E.D. Va. 1968).

<sup>58</sup> The court stated in the course of the opinion that, except for the ownership of stock and the interlocking directorates, "[t]here is nothing to establish that Texaco exercised dominion or control over Export or Panama, or directed their policies, or maintained their records, finances, properties or rights, or directed either of their operations." *Id.* at 1005.

found "no evidence . . . of injustice or fraud or wrong . . .",<sup>59</sup> it held for the defendant.

*G.E.J. Corp. v. Uranium Aire, Inc.*,<sup>60</sup> exemplifies yet another rubric under which the corporate entity is disregarded—the "alter-ego" theory.<sup>61</sup> Therein, Uranium Aire, Inc. (Uranium) had granted an option to G.E.J. Corporation (GEJ) to purchase certain property owned by Uranium. GEJ agreed that during the term of the option it would mine a certain amount of uranium ore or, in the alternative, pay Uranium \$75,000. Prior to the termination date GEJ repudiated the option, and, as a result, Uranium sued both GEJ and its parent, M.F. Corporation (MF). In holding MF liable on the option agreement, the court explicated the alter-ego doctrine as applied in California:

California law established two requirements for an alter-ego relationship: first, that the subsidiary is not only influenced and governed by the parent, but that there is such unity of interest and ownership that their individuality or separateness has ceased; second, that the facts are such that an adherence to normal attributes or separate corporate existence would sanction a fraud or promote injustice.<sup>62</sup>

The first element, the "unity of interest and ownership", was apparently fulfilled because "GEJ conducted no independent business but was owned, controlled, and operated as a conduit for [MF's] . . . purchase of the property."<sup>63</sup> GEJ was under complete control of MF, and MF had paid for the option, the cost of exploring the property and other expenses of GEJ. The requirement that injustice result from recognizing the corporate existence was met because GEJ was undercapitalized and

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<sup>59</sup> *Id.* at 1006-07.

<sup>60</sup> 311 F.2d 749 (9th Cir. 1963).

<sup>61</sup> For a discussion of the alter-ego doctrine, see N. LATTIN, *THE LAW OF CORPORATIONS* 86-87 (2d ed. 1971). The instrumentality theory and the alter-ego theory are often used interchangeably. See, e.g., *Fisser v. International Bank*, 282 F.2d 231 (2d Cir. 1960), a case in which the court used the Powell formulation as appropriate to determine when the corporate entity should be disregarded, but the court refused to find the owners liable because the plaintiffs had "failed to prove that Allied was the respondent's alter-ego." *Id.* at 241.

<sup>62</sup> *Id.* at 756.

<sup>63</sup> *Id.*

MF had made assurances that it would stand behind GEJ's obligations.<sup>64</sup>

### B. *A More Realistic Formulation*

Although other commentators have advanced different theories under which the corporate entity may be disregarded,<sup>65</sup> Professor Latty has formulated the most realistic standard; one which is, in fact, often utilized by the courts. Latty remarked that "[w]hat the formula comes down to, once shorn of verbiage about control, instrumentality, agency and corporate entity, is that the liability is imposed to reach an equitable result."<sup>66</sup> Research confirms Latty's observation.

Stated more precisely, the courts, in determining whether to disregard the corporate entity, examine all the factors of the particular case and make a determination, in light of those factors, whether it is necessary to disregard the corporate existence in order "to reach an equitable result."<sup>67</sup> This same analysis occurs whether the theory professedly applied is called the instrumentality theory, the alter-ego theory, or some other theory.<sup>68</sup> The factors emphasized by the courts in determining

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<sup>64</sup> *Id.* at 755. Other California cases have discussed factors that show unfairness. Thus, for example, in *Automotriz Del Golfo De California v. Resnick*, 306 P.2d 1 (Cal. 1957) the court emphasized undercapitalization and failure to issue stock. For other California cases emphasizing the non-issuance of stock as a relevant factor in determining whether the alter-ego doctrine should be applicable, see *Geisenhoff v. Mabrey*, 137 P.2d 36 (Cal. 1943); *Marr v. Postal Union Life Ins. Co.*, 105 P.2d 649 (Cal. 1940).

<sup>65</sup> See, e.g., *Annot.*, 38 A.L.R.3d 1103 (1971); Comment, *Alternative Methods of Piercing the Corporate Veil in Contract and Tort Cases*, 48 BOSTON U.L. REV. 123 (1968).

<sup>66</sup> E. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 191 (1936). A similar test for disregard of the corporate entity was proposed by Mr. Justice Cardozo in *Berkey v. Third Ave. Ry.*, 155 N.E. 58, 61 (N.Y. 1926) where he stated: "Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice." See also Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1402 (1938).

<sup>67</sup> In an excellent article by Professor Hamilton, he makes the observations that, after courts have looked at various factors in determining whether to respect the corporate entity, "the conclusion that the shareholder is liable may be buttressed by the meaningless statement that such acts make the corporation the shareholder's 'alter ego' or 'instrumentality.'" Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 990 (1971).

<sup>68</sup> An example of a case in which this was recognized was *Zaist v. Olsen*, 227 A.2d 552 (Conn. 1967). Although clearly utilizing the "instrumentality" theory to find the

whether to disregard the corporate entity are not a function of the theory used. Rather, certain facts seem to reappear in all cases, notwithstanding that different tests are being applied.<sup>69</sup>

It is impossible to say that the presence of any factor or any combination of factors will result in a disregard of the corporate entity. Nevertheless, a combination of some or all of the following factors is usually present in cases where the corporate entity is disregarded.

### 1. Control

Although it is clear that mere stock ownership will not result in the owner of a corporation being held liable for its obligations,<sup>70</sup> some element of control seems indispensable to the disregard of the corporate entity.<sup>71</sup> An example of the importance of the element of control can be seen in *Fisser v. International Bank*,<sup>72</sup> a case in which the plaintiff was attempting to hold the owner (parent corporation) liable under the terms of a contract entered into with the subsidiary. Although the subsidiary's officers were all high-ranking officials in the parent company and although the parent was either the dominant or sole shareholder in the company, the court refused to disregard the corporate entity, because the plaintiff "failed to prove [the necessary degree of] . . . control . . . ." The court found that the parent's action did not constitute the type of

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owners of the corporation liable, the court stated that limited liability "will be disregarded where, as here, the interests of justice and righteous dealing so demands. . . ." *Id.* at 557.

<sup>69</sup> Compare *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962) (a case using the "alter-ego" doctrine and emphasizing as a basis for the decision control, undercapitalization and representations of parent that it would back up the subsidiary), with *Gledhill v. Fisher & Co.*, 262 N.W. 371 (a case using Powell's instrumentality theory, but also emphasizing control and undercapitalization).

<sup>70</sup> See, e.g., *Chichester v. Polikowsky*, 231 F.2d 183 (9th Cir. 1955); *Sirmons v. Arnold Lumber Co.*, 167 So. 2d 588 (Fla. Ct. App. 1964); *Kroger Co. v. J. Weingarten, Inc.*, 380 S.W.2d 145 (Tex. 1964).

<sup>71</sup> See, e.g., *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1963), a case in which the court upheld a lower court's disregard of the corporate entity only after finding that the parent "retained actual control of GEJ and made all important decisions with respect to the transaction." *Id.* at 756. One commentator stated that "some degree of dominance is found in all the cases where plaintiffs seek successfully or unsuccessfully to hold liable a shareholder or affiliate." Comment, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441, 448 (1967).

<sup>72</sup> 282 F.2d 231 (2d Cir. 1960).



direct, "meddling with management" necessary to pierce the corporate veil. Rather, the court stated, "it is equally plausible to ascribe the acts to the . . . [officers of the subsidiary] as . . . executives participating in a manner normally usual for stockholders and directors of an independent corporation." In addition, the court found the control of the parent diminished because of the presence of outsiders on the board of directors of the subsidiary.<sup>73</sup>

The cases indicate that the more pervasive the control exercised over the corporation by the owners, the more likely the courts are to disregard the corporate entity.<sup>74</sup> This is reflected in the fact that cases in which courts have disregarded the corporate entity generally involve an owner's intrusion into the day-to-day affairs of the corporation. An example of this can be found in *Consolidated Rock Co. v. Du Bois*.<sup>75</sup> That case involved a reorganization under the Bankruptcy Act of Consolidated and its two wholly-owned subsidiaries (Union and Consumers). The Supreme Court held that the creditors of Union and Consumers were entitled to look to the assets of Consolidated for payment. Although there were other factors involved, the Court was admittedly influenced by the degree of intrusion by Consolidated into the affairs of Union and Consumers. Justice Douglas, writing for the majority, stated that "it is well settled that where a holding company directly intervenes in the management of its subsidiaries, it is responsible for the obligations of those subsidiaries incurred or arising during its management."<sup>76</sup> In *Consolidated* this direct intervention by the parent was readily apparent because an "operating agreement", which turned over to the parent the "entire management, operation and financing" of the subsidiaries, had been executed between the parent and the subsidiaries. This ele-

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<sup>73</sup> *Id.* at 238.

<sup>74</sup> The language of numerous cases indicates that pervasive control is a prerequisite for disregard of the corporate entity. See e.g., *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1963) (requiring that "the subsidiary is not only influenced and governed by the parent, but that there is such unity of interest and ownership that their individuality or separateness has ceased . . ."); *Zaist v. Olson*, 227 A.2d 552 (Conn. 1967) ("There must be 'such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal.'" *Id.* at 557 (citation omitted).

<sup>75</sup> 312 U.S. 510 (1941).

<sup>76</sup> *Id.* at 524.

ment of pervasive control is demonstrated by other cases in which the corporate entity has been disregarded.<sup>77</sup>

Finally, it is apparent that control alone will generally not support a disregard of the corporate entity. As will be recalled, the more traditional formulation of Professor Powell requires that, in addition to control, there must be a finding that the "control . . . was exercised . . . in such a manner as to defraud or wrong the complainant"<sup>78</sup> and that a refusal to disregard the corporate entity "would result in an unjust loss or injury to the complainant."<sup>79</sup> In addition to Powell's statements, numerous cases indicate that other factors must be present in order to impose liability upon the owners. Some cases have specifically refused to find liability because only control was shown.<sup>80</sup> Other cases have assessed liability against the owners of corporations, but only after finding that other factors beyond mere control were present.<sup>81</sup>

## 2. Undercapitalization

Corporate undercapitalization is often a factor in a court's decision to disregard the corporate entity.<sup>82</sup> While it has been stated that undercapitalization alone will not support a disregarding of the corporate entity,<sup>83</sup> it is generally present in cases holding the owners liable for corporate obligations.<sup>84</sup> As one

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<sup>77</sup> See, e.g., *Consolidated Sun Ray, Inc. v. Oppenstein*, 335 F.2d 801 (8th Cir. 1964); *Zaist v. Olsen*, 227 A.2d 552 (Conn. 1967).

<sup>78</sup> POWELL, *supra* note 33, at 5.

<sup>79</sup> POWELL, *supra* note 33, at 6.

<sup>80</sup> See, e.g., *Sirmons v. Arnold Lumber Co.*, 167 So. 2d 588 (Fla. Ct. App. 1964) ("The corporate veil will not be pierced when it is not shown that the corporation was used to mislead creditors or for fraudulent purposes; without more, the mere fact that one or more individuals control the corporate activity is not sufficient to justify imposition of the corporate debt upon the shareholders . . . ." *Id.* at 589-90.)

<sup>81</sup> See, e.g., *Rounds & Porter Lumber Co. v. Burns*, 225 S.W.2d 1 (Ark. 1949).

<sup>82</sup> See Comment, 28 OHIO ST. L.J. 441, 460 (1967) ("it is more or less present in all cases"). This discussion should be distinguished from the requirement in some states that a corporation have a minimum paid-in capital before it begins business. See, e.g., S.C. CODE ANN. § 12-14.6 (1962) (prohibiting a company from transacting any business or incurring any indebtedness until it received one thousand dollars for stock, five hundred of which must be in cash.) The recent revision of the corporation law of Kentucky eliminated a similar provision. See Note, *Organizing the Corporation Under the New Business Corporation Act — A Comparison with Prior Law*, 61 KY. L.J. 95, 106 (1972).

<sup>83</sup> *Fisser v. International Bank*, 282 F.2d 231, 240 (2d Cir. 1960).

<sup>84</sup> E.g., *Shafford v. Otto Sales Co.*, 308 P.2d 428 (Cal. Ct. App. 1957).

court stated, "the proper rule is that inadequate financing, where such appears, is a factor, an important factor, in determining whether to remove the insulation to stockholders . . . ." <sup>85</sup> This means that if a corporation transacts business with assets that are deemed to be inadequate, it increases the probability that the limited liability of its owners will not be respected. <sup>86</sup>

One obvious problem is the need to define the standard of inadequacy. <sup>87</sup> Professor Lattin has perhaps accurately described "adequate capitalization" as the amount a "reasonably prudent man with a general knowledge of the particular type of business and its hazards would determine was reasonable . . . in light of any special circumstances which existed at the time of incorporation . . . ." <sup>88</sup> Beyond this general statement, however, it is hard to qualify the concept of undercapitalization. One court found undercapitalization where the owners had contributed \$5,000 and had a business volume of \$100,000 to \$150,000 per month. <sup>89</sup> In another case, the court found undercapitalization of a subsidiary that had capital consisting of only a \$1,000 demand note (of which only \$300 had been paid). The subsidiary had entered into a contract with potential liability of \$75,000. <sup>90</sup>

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<sup>85</sup> *Carlesimo v. Schwebel*, 197 P.2d 167, 174 (Cal. Ct. App. 1948).

<sup>86</sup> Although seldom articulated, the requirement of adequate capitalization means that the net assets of the corporation must be adequate. Net assets are defined in the Model Act as "the amount by which the total assets of a corporation exceed the total debts of the corporation." MODEL BUSINESS CORPORATION ACT § 2(j) (1969). This would be represented by the equity accounts. *See, e.g., Hichle v. Torrance Millworks, Inc.*, 272 P.2d 780 (Cal. Ct. App. 1954) (finding undercapitalization because "[t]he corporation started out owing money equal to the value of the assets. Its net worth was nil." *Id.* at 783).

<sup>87</sup> For suggestions as to what constitutes undercapitalization see *Symposium — The Close Corporation*, 52 NW. U.L. REV. 345, 369-70 (1957).

<sup>88</sup> N. LATTIN, *supra* note 61, at 77-78. Ballantine stated that "shareholders should in good faith put at the risk of the business unencumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege." H. BALLANTINE, CORPORATIONS 303 (Rev. ed. 1946). It has been suggested that that test of adequacy of capitalization may differ depending on the issue involved. Comment, 28 OHIO ST. L.J. 441, 459 (1967).

<sup>89</sup> *Automotriz Del Golfo De California v. Resnick*, 306 P.2d 1 (Cal. 1957).

<sup>90</sup> *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962). In another case a corporation was deemed undercapitalized where the corporation had been started with only \$7,700 while doing nearly two million dollars in business a year. *Remme v. Herzog*, 35 Cal. Rptr. 586 (Cal. Ct. App. 1963).

In determining the adequacy of capitalization, courts have sometimes relied on a corporation's pre-incorporation existence (assuming, of course, that there was one) as a norm for post-incorporation adequacy of capital.<sup>91</sup> Applying this rule, a California court, in affirming a lower court decision that had held the owners of a corporation liable on the corporate debt, emphasized that "just before the incorporation of the corporation, the business had a net worth of \$325,000. Notwithstanding this, the corporation began business with an invested capital of only \$7,700."<sup>92</sup>

One problem in undercapitalization cases that has troubled both commentators and judges is the determination of the point in time at which undercapitalization is measured. Language from cases generally indicates that the critical time is that of incorporation.<sup>93</sup> Professor Hamilton has flatly stated that "[i]nadequate capitalization is measured at the time of formation of the corporation."<sup>94</sup> There are, however, some fairly obvious exceptions to this rule. Most cases indicate that if an adequately capitalized corporation subsequently becomes impecunious, the corporation may be judged to be undercapitalized, especially if the cause of the insolvency is due to gross mismanagement by the owners. Thus, if the corporation paid dividends so large as to cripple the corporation and make it insolvent<sup>95</sup> or if the corporation is prevented from making a profit because it sells its products to the owners at a reduced price,<sup>96</sup> it may be judged to be inadequately capitalized, notwithstanding that it had sufficient capital at its inception.<sup>97</sup> Generally, however, if a corporation is adequately capitalized at the outset, the erosion of its capital by the fortunes of business will not expose the owners to personal liability.<sup>98</sup>

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<sup>91</sup> N. LATTIN, *supra* note 61, at 78.

<sup>92</sup> *Remme v. Herzog*, 35 Cal. Rptr. 586, 589 (Cal. Ct. App. 1963).

<sup>93</sup> *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962).

<sup>94</sup> Hamilton, *supra* note 49, at 986.

<sup>95</sup> *Burton v. Roos*, 20 F. Supp. 75 (W.D. Tex. 1937), *aff'd*, 93 F.2d 380 (5th Cir. 1937).

<sup>96</sup> *Rounds & Porter Lumber Co. v. Burns*, 225 S.W.2d 1 (Ark. 1949).

<sup>97</sup> See generally Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1129 (1958).

<sup>98</sup> See the cases cited in Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122 n.52 (1958); see also cases cited in Hamilton, *supra* note 49, at 936 n.25.

### 3. *Splitting the Economic Unit*

Splitting a single economic enterprise into smaller corporate units is a practice that increases the risk a court will disregard the corporate entity.<sup>99</sup> Professor Berle used this "enterprise entity" theory to explain many of the cases in which a parent corporation was held liable for the debts of a subsidiary.<sup>100</sup> Berle's notion was that the assets available to satisfy creditors of a corporation should be determined by economics, not mere legal form. Thus, if a creditor has a claim against a subsidiary, the assets of the parent should be available to satisfy the claim, *if* the subsidiaries have "become, . . . as a business matter, more or less indistinguishable parts of a larger enterprise."<sup>101</sup> An example of this is where a lease or other interest in property is taken by a subsidiary but is utilized by the parent in the latter's business. In that situation, courts have sometimes disregarded the corporate entity of the subsidiary and held the parent corporation liable.<sup>102</sup>

In *Burton v. Roos*<sup>103</sup> the court looked to the splitting of the economic unit as a factor in assessing liability against the owners of the corporation. There the plaintiff had recovered a judgment against the Texas Company of Mexico (Mexico), and the issue was whether that judgment should be enforceable against the parent of Mexico. In holding the parent liable, the court emphasized that "the sole purpose of the corporation of [Mexico] . . . was to enable the Texas Corporation [the parent]<sup>104</sup> to produce oil and to do an oil business, etc., in Mexico

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<sup>99</sup> Hamilton, *supra* note 49, at 985. This has been raised, with varying degrees of success, in tort cases where, for example, an individual will utilize multiple corporations, each owning a small amount of property. See, e.g., *Black & White, Inc. v. Love*, 367 S.W.2d 427 (Ark. 1963); *Walkovszky v. Carlton*, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966); *Robinson v. Chase Maintenance Corp.*, 190 N.Y.S.2d 773 (Sup. Ct. 1959).

<sup>100</sup> Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

<sup>101</sup> *Id.* at 348.

<sup>102</sup> *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962). The use by a parent of an interest in land taken by a subsidiary will not always result in a disregard of corporate entity. Rather, it is merely one factor. See, e.g., *Gledhill v. Fisher & Co.*, 262 N.W. 371 (Mich. 1935).

<sup>103</sup> 20 F. Supp. 75 (W.D. Tex. 1937), *aff'd*, 93 F.2d 380 (5th Cir. 1937).

<sup>104</sup> *Id.* at 78. As with all cases in which the corporate entity is disregarded, more than one factor was involved in the court's decision. The court in *Burton* also found undercapitalization, pervasive control and the payment of large dividends that drained the company's cash supply.

...” The parent was also in the oil business and simply had split the economic entity.

Another example of a court refusing to respect the corporate entity of a component of a single economic unit is *Zaist v. Olson*.<sup>105</sup> In that case Martin Olson had created and controlled a number of companies that were utilized in his real estate development enterprise. Plaintiff agreed to make some improvements on land owned by Olson personally. Although it was unclear which of the Olson enterprises contracted with the plaintiff, East Haven made the payments for the work. When the plaintiff was unable to collect the last \$28,000 on the contract, he sued East Haven, Olson Inc. and Olson personally. In holding that the plaintiff was not limited to the resources of East Haven, the court stressed that East Haven was but one part of a large enterprise, again showing the courts' tendency to ignore the artificial splitting of an economic unit. The court stated that East Haven “had no proprietary interest in the property on which the work was done, and so far as appears, it gained nothing from whatever part it played in the transaction.”<sup>106</sup> It went on to emphasize that East Haven “was used by Olson for the benefit of Olson . . . .”<sup>107</sup>

#### 4. *Maintenance of Corporate Formalities*

The failure to maintain the requisite corporate formalities substantially increases the probability that the corporate existence will be disregarded.<sup>108</sup> One such formality often discussed by the courts is the maintenance of fiscal separateness between the corporate owners and the corporation. For example, the New York court, in refusing to hold a parent corporation liable

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<sup>105</sup> 227 A.2d 552 (Conn. 1967).

<sup>106</sup> *Id.* at 555.

<sup>107</sup> *Id.* at 557.

<sup>108</sup> See generally 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 751 (Supp. 1968). Conversely, the maintenance of corporate formalities is often heavily relied on by courts in refusing to pierce the corporate veil. See, e.g., *Fisser v. International Bank*, 282 F.2d 231 (2d Cir. 1960), a case in which the court, in refusing to hold the owners of a corporation liable, stated that it was “pointed to no authorities which justify a disregard of a corporation's separate existence merely because of its undercapitalization when its controlling stockholder has at least regarded the formalities of such existence.” *Id.* at 240. See also *Ohio Edison Co. v. Warner Coal Corp.*, 72 N.E.2d 487 (Ohio Ct. App. 1946).

for the obligations of its subsidiary, emphasized that the subsidiary made its own contracts, kept its own accounts, collected its own revenues and paid its own operating expenses.<sup>109</sup> Another court held that the plaintiff, suing on a lease entered into with a corporation, had stated a cause of action against the owners of the corporation where he alleged that

funds were shifted about . . . between the owners and the corporation without regard to formality and to suit their immediate convenience, that the deposit on the corporate lease was paid by personal check of the shareholder without any formal agreement for repayment and that the owners had individually paid the taxes on the property.<sup>110</sup>

Other courts have interpreted the maintenance of separate offices and the filing of separate reports to government agencies as evidence of separate existence.<sup>111</sup> In California, the non-issuance of stock is evidence of unity in the affairs of the corporation and its owners.<sup>112</sup> In addition to the foregoing, Professor Hamilton has listed the following as creating a "substantial risk that the separate corporate existence will be ignored": not holding director and shareholder meetings, making decisions by the owners as though they were partners, the absence of a sharp distinction between corporate property and personal property, and the absence of complete corporate and financial records.<sup>113</sup>

Disregarding the corporate entity due to a lack of corporate formalities has been soundly criticized by commentators. Professor Fuller, writing in 1938, observed that "it is not at all clear that a [sole shareholder's] previous failure to observe a nice distinction between his dual capacities as individual and

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<sup>109</sup> *Stone v. Cleveland C.C. & St. L. Ry.*, 95 N.E. 816 (1911).

<sup>110</sup> *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344, 345 (2d Cir. 1942). See also *African Metals Corp. v. Bullowa*, 41 N.E.2d 466 (1942), holding that plaintiff stated a cause of action against the owners of a corporation where, *inter alia*, the day-to-day financing of the corporation was handled out of shareholder funds.

<sup>111</sup> See, e.g., *Eisenbarth v. Equity Mutual Ins. Co.*, 189 S.W.2d 168 (Mo. 1945). But see *Consolidated Sun Ray, Inc. v. Oppenstein*, 335 F.2d 801 (8th Cir. 1964), where the court pierced the corporate veil in spite of the fact that the subsidiary corporation filed separate documents with appropriate government agencies.

<sup>112</sup> *Geisenhoff v. Mabrey*, 137 P.2d 36 (Cal. Ct. App. 1943); *Marr v. Postal Union Life Ins. Co.*, 105 P.2d 649 (Cal. Ct. App. 1940).

<sup>113</sup> *Hamilton*, *supra* note 49, at 990.

corporate officer should bring upon his head the penalty of personal liability.”<sup>114</sup> Generally, the observation has been made that “confusion and informality are not related to the claim advanced by . . . contract plaintiffs” and that the disregard of the corporate entity solely because of the presence of such circumstances therefore creates “a windfall” for the plaintiff, who was in no way harmed by the confusion and informality.<sup>115</sup> It has also been pointed out that a strict requirement of formality may be troublesome for the smaller, closely held companies, notoriously lax in following the corporate formalities.<sup>116</sup> If, however, the lack of distinction between the corporate and personal affairs of the owner misled the contracting plaintiff into believing that he was dealing with the owners individually, commentators and courts generally have agreed that owners should be liable for the obligation.<sup>117</sup>

Notwithstanding this criticism, courts normally are more inclined to disregard the corporate entity in those situations in which the owners of the corporation have disregarded corporate formalities.<sup>118</sup>

### 5. Estoppel

Estoppel is sometimes mentioned by courts as an important factor in a determination to disregard the corporate entity.<sup>119</sup> Although the concept of estoppel, as used in this context, does not mean that all the elements of a common law estoppel<sup>120</sup> must be met,<sup>121</sup> the two notions are clearly related. In a

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<sup>114</sup> Fuller, *One-Man Corporations*, 51 HARV. L. REV. 1373, 1381 (1938).

<sup>115</sup> Hamilton, *supra* note 49, at 990.

<sup>116</sup> *Id.* at 991.

<sup>117</sup> Professor Fuller advocated personal liability of a sole shareholder in this situation. Fuller, *supra* note 114, at 1379. See also *Bartle v. Home Owners Cooperative, Inc.*, 127 N.E.2d 832, 140 N.Y.S.2d 512 (1955) (court refused to pierce the corporate veil where “outward indicia of . . . separate corporations was at all times maintained . . . [and] creditors were in no wise misled . . .” *Id.* at 833).

<sup>118</sup> See generally H. BALLANTINE, *supra* note 88, at 294 (1946).

<sup>119</sup> POWELL, *supra* note 33, at § 13(e).

<sup>120</sup> A good statement of the common law doctrine of estoppel is found in 1 S. WILLISTON, LAW OF CONTRACTS § 139 (3d ed. 1957) wherein the author states:

It is generally held that representations of fact made to a party who relies thereon with the right to so rely may not be denied by the party making the representations if such denial would result in injury or damage to the relying party.

<sup>121</sup> POWELL, *supra* note 33, at § 13(e).



decision to disregard the corporate entity, "estoppel" describes a court's response if misrepresentations have been made or if deceptive appearances have been permitted to go uncorrected. In that situation it may be unfair to respect the limited liability of the owners of the corporation.

One typical situation is an indication by the controlling shareholder that he will guarantee the obligations of the corporation. Thus, where the parent gave "assurances that it would back up [the subsidiary's] . . . obligations"<sup>122</sup> or where the owners of a corporation indicated that they "stood behind" a lease taken by their corporation,<sup>123</sup> courts considered these to be important factors in deciding whether to disregard corporate entity.

Another type of misrepresentation can occur if the complaining party is not made aware of the fact he is dealing with a corporation. In that situation he can be misled into believing that all the assets of an individual are available to settle any claims he may have. This was the view expressed in *Shafford v. Otto Sales Company*,<sup>124</sup> where the California court, while placing primary emphasis on undercapitalization and failure to issue stock, emphasized that the plaintiff thought he was dealing with the majority shareholder personally.

It is important to note that this element of estoppel is independent of any action for fraud and deceit, which a party may have against the owners of a corporation. If the plaintiff can establish the element of common law deceit against the owners, he clearly could recover under that theory.<sup>125</sup> Estoppel, as it is used in the cases involving a piercing of the corporate veil, is simply one factor that is considered in determining whether fairness requires the disregard of the corporate entity. As one court has stated, "It is not a question of whether plaintiff was actually defrauded but whether he is bound to accept as facts the illusions the defendant created."<sup>126</sup>

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<sup>122</sup> *G.E.J. Corp. v. Uranium Aire, Inc.*, 311 F.2d 749 (9th Cir. 1962).

<sup>123</sup> *Weisser v. Mursam Shoe Corp.*, 127 F.2d 344 (2d Cir. 1942).

<sup>124</sup> *Shafford v. Otto Sales Co.*, 308 P.2d 428 (Cal. 1957).

<sup>125</sup> See generally W. PROSSER, *LAW OF TORTS* 685-86 (4th ed. 1971) for the elements of recovery for deceit.

<sup>126</sup> *Hiehle v. Torrance Millworks, Inc.*, 272 P.2d 780, 784 (Cal. 1954).

## 6. *Deadly Combination*

It is impossible to state that any particular combination of the foregoing factors will result in a disregard of the corporate entity. After extensive research, however, one does arrive at certain general conclusions. One such conclusion is that excessive shareholder control and undercapitalization are present in virtually every case in which the corporate entity is disregarded.<sup>127</sup> Also, cases in which the owners of a corporation are held liable for corporate obligations usually involve at least one of the other above-discussed factors.<sup>128</sup> In light of this, any person who owns a corporation creates a substantial risk of personal liability if he dominates the day-to-day affairs of the corporation and the corporation is undercapitalized. Further, the presence of any of the other factors described above increases the probability of a disregard of the corporate entity.

## C. *Kentucky Cases*

Kentucky cases<sup>129</sup> indicate that, in an appropriate in-

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<sup>127</sup> Consolidated Sun Ray, Inc. v. Oppenstein, 335 F.2d 801 (8th Cir. 1964); G.E.J. Corp. v. Uranium Aire, Inc., 311 F.2d 749 (9th Cir. 1962); Weisser v. Mursam Shoe Corp., 127 F.2d 334 (2d Cir. 1942); Automotriz Del Golfo De California v. Resnick, 306 P.2d 1 (Cal. 1957); Remme v. Herzog, 35 Cal. Rptr. 586 (Cal. Ct. App. 1963); Zaist v. Olson, 227 A.2d 552 (Conn. 1967).

<sup>128</sup> E.g., G.E.J. Corp. v. Uranium Aire, Inc., 311 F.2d 749 (9th Cir. 1962) (estoppel).

<sup>129</sup> Up to this point I have utilized only contract cases. When one begins to analyze the law in Kentucky, however, the dearth of cases on the subject makes such an approach impossible. There simply are not enough contract cases to give one an accurate projection of when a Kentucky court would pierce the corporate veil in a contract situation. Accordingly, it was necessary to consider cases other than contract cases.

Since these non-contract cases are generally limited to tort cases, an appropriate question is whether tort cases are authority for contract situations. Generally, the same factors that are relevant to the determination to disregard the corporate entity in a tort case are relevant in a contract case. Thus, for example, tort cases emphasize such factors as undercapitalization and disregard of corporate formalities as relevant to the decision of whether the corporate entity should be disregarded. See H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* 254 (2d ed. 1970). In fact, tort and contract cases are sometimes treated together by commentators. See, e.g., H. BALLANTINE, *supra* note 88, at 298; N. LATTIN, *supra* note 61, at 72-79.

This is not to say, however, that the factors considered in tort cases are identical to the contract situation. One obvious difference is that in the contract situations the parties can choose the assets that are to be subjected to liability. In the tort situation, however, this is not true. Thus it has been suggested that undercapitalization should be more important in the tort situation, as that plaintiff has not chosen to deal with defendant. See Hamilton, *supra* note 49, at 988.

stance, the corporate entity will be disregarded and the owners will be held liable for the debts of the corporation. Language from one case states that the courts will look beyond the corporate shell if the corporation is "the business conduit or alter ego" of the owners.<sup>130</sup> Another case states that the court will "on appropriate occasions ignore the distinction between . . . [a parent and a subsidiary corporation] where its recognition would operate as a shield for fraudulent or criminal acts where subversive of the public policy of a state."<sup>131</sup>

While it is clear that the Court of Appeals will disregard the corporate entity in some instances, its past decisions are of minimal help in assessing the present state of the law. Initially, one is confronted by the problem that there are a limited number of reported cases in which this issue has been raised. Moreover, since most of those decisions are forty or more years old, there could be some doubts as to their continued vitality as precedent.

Finally, the attitude of the Kentucky Court — a general aversion for *any* disregard of the corporate entity — has contributed to the uncertainty. While this attitude is, in itself, some indication of the present state of the law, it has contributed to the lack of clarity in this area. One result of this position is that there is an extremely limited number of cases in which the corporate entity has been disregarded,<sup>132</sup> and consequently there is little indication of what combination of factors would result in a disregard of the corporate entity. Additionally, this grudging attitude has often caused courts to dismiss claims against owners with almost no discussion,<sup>133</sup> a practice which further contributes to the uncertainty.

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<sup>130</sup> *Smith v. Henry Knight & Son*, 277 S.W. 290 (Ky. 1925) (involving an attempt to find liability against a corporation under the same control as the corporation entering the contract).

<sup>131</sup> *Big Four Mills, Ltd. v. Commercial Credit Co.*, 211 S.W.2d 831 (Ky. 1948). See also *Lowery Watkins Mortgage Co. v. Turley-Bullington Mortgage Co.*, 58 S.W.2d 591 (Ky. 1933) (defendant sued on a debt attempted to assert as a set-off liability against the owners of corporate plaintiff); *Ayer & Lord Tie Co. v. Commonwealth*, 271 S.W. 693 (Ky. 1925) (parent and subsidiary claiming one entity for tax purposes).

<sup>132</sup> One case in which the Court did disregard the corporate entity was *Louisville & Nashville R. Co. v. Carter*, 10 S.W.2d 1064 (Ky. 1927). Although that case was a tort case, it does indicate the factors necessary to disregard the corporate entity.

<sup>133</sup> See, e.g., *Gravel Switch & Little South Tel. Co. v. Lebonnon L. & L. Tel. Co.*, 129 S.W. 559 (Ky. 1910). In that case the Kentucky Court, with no analysis, dismissed

An examination of the reported cases, however, reveals nothing radical in the Kentucky approach. On the contrary, the Kentucky Court of Appeals appears to be sensitive to the same factors as the courts in other jurisdictions. The cases in Kentucky thus place heavy emphasis upon the requirement of control.<sup>134</sup> An example is *Smith v. Henry Knight & Son*,<sup>135</sup> in which the plaintiff had contracted with Louisville Rendering Company (LRC) to sell the latter a quantity of dry blood. When LRC refused to accept delivery or make payments called for by the contract, the plaintiff sued Henry Knight & Son (Knight), alleging that Knight was liable under the contract because it was the alter-ego of LRC. In rejecting the plaintiff's claim, the Court emphasized that there was "no evidence in the record that the Henry Knight & Son Corporation in any way controlled the Louisville Rendering Company . . . ." The Court later expressed the importance of control by saying that "[i]n order to hold one corporation liable for the debts of another, it must appear that they are the business conduits or the alter ego of one another."<sup>136</sup>

While control does appear to be a prerequisite for a disregard of the corporate entity, the Court has indicated that control alone is not enough to cause that result. As it once noted,

the fact that the one corporation exercised a controlling influence over the other through the ownership of its stock or through the identity of stockholders [does not] operate to make either the agent of the other or to merge the two corporations into one.<sup>137</sup>

Again, this is consistent with other jurisdictions.

There is also some indication that the Kentucky courts would consider the notion of estoppel in determining whether

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a claim that the corporate entity of a subsidiary corporation should be disregarded. The Court simply stated, "[A]lthough [the parent] may own all the stock in the [subsidiary], it is not liable for the breach by that company of its contracts. A stockholder in a . . . company is not liable for the obligations of the company." *Id.* at 562. *Accord*, *Big Four Mills Ltd. v. Commercial Credit Co.*, 211 S.W.2d 831, 834 (Ky. 1948).

<sup>134</sup> The absence of control appears to have been an important factor in the Court's refusal to disregard the corporate entity in *Southeastern Greyhound Lines v. Harden's Adm'x*, 136 S.W.2d 42 (Ky. 1940).

<sup>135</sup> 277 S.W. 290 (Ky. 1925).

<sup>136</sup> *Id.* at 291.

<sup>137</sup> *H. Richmond & Irvine Constr. Co. v. Richmond, Nicholasville, Irvine & Beattyville R.R.*, 68 F. 105 (6th Cir. 1895).

to disregard the corporate entity. In *Richmond & Irvine Construction Company v. Richmond, Nicholasville, Irvine & Beattyville Railroad Company*,<sup>138</sup> Richmond & Irvine Construction Company had entered into a contract with Ohio Valley Improvement & Contract Company to complete construction of a railroad. Subsequently, the construction company attempted to hold Richmond, Nicholasville, Irvine & Beattyville Railroad Co. liable under the terms of the contract. In refusing to so hold, the Court emphasized that the liabilities of the parties at the time of the signing were made clear. It stated that there was

no pretense of any fraudulent concealment of the interest of the corporation in the other . . . . With this knowledge of the relations of each corporation to the other, it deliberately entered into a contract with the contract company . . . .<sup>139</sup>

Although this case is nearly 80 years old, it does suggest that a Kentucky court would consider representations and disclosures in deciding whether to disregard the corporate entity.

The maintenance of corporate formalities also appears to be an important factor in Kentucky cases. In *Pike Motor Company v. Adams*,<sup>140</sup> J.W. Tomblin, Jr. was a shareholder in both Tomblin-Ford Company, Inc. and Pike Motor Company, Inc. When Tomblin-Ford Company was unable to perform its part of a lease agreement with Adams, Adams sued Pike Motor Company and J.W. Tomblin, Jr. In reversing a lower court's decision holding J.W. Tomblin, Jr. and Pike Motor Company liable, the Court emphasized that the plaintiff had failed to show that the affairs of the corporations were commingled:

It was conclusively shown the Pike Motor Co., Inc., and Tomblin-Ford Co., Inc., were separate and distinct corporate entities, and their only relationship was that of debtor and creditor. An effort was made on the part of appellees to prove these two corporations had commingled their property, but it is our view the evidence fell far short of establishing such a fact.<sup>141</sup>

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<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 108.

<sup>140</sup> 380 S.W.2d 94 (Ky. 1964).

<sup>141</sup> *Id.* at 95.

Likewise, in *C.L.&L. Motor Express Co. v. Achenback*,<sup>142</sup> a case in which the plaintiff unsuccessfully attempted to hold the defendant-corporation liable for a tort committed by a sister corporation, the Court emphasized the separateness of the two corporations. The Court stated that although the two corporations occupied the same premises and shared employees, "the C.L.&L. Company was charged with rental by the Union Company" and "each [company] was charged with a proportionate part of [the employees'] salaries."<sup>143</sup> In that situation, the Court refused to pierce the corporate veil because corporate formalities were strictly adhered to.<sup>144</sup>

While not specifically articulated by the Kentucky courts, it appears that they have given some weight to the enterprise entity theory advanced by Professor Berle. An example is *Louisville & N.R. Co. v. Carter*,<sup>145</sup> a case in which the plaintiff successfully sued the parent company for injuries caused by the negligence of the subsidiary. While there were other factors involved in the Court's decision, one important factor was that the subsidiary railroad had become an indistinguishable part of the larger economic unit of the parent.

While it is difficult to predict what factual combination would persuade a Kentucky court to disregard the corporate entity, further examination of the preceeding case establishes some guidelines.<sup>146</sup> In that case the plaintiff was injured when a train operated by the Frankfort & Cincinnati Railroad Company collided with an automobile. The trial court rendered a decision in favor of the plaintiff, disregarding the corporate entity of Frankfort & Cincinnati and holding the parent corporation, the L & N Railroad, liable. In affirming this decision the Court of Appeals placed primary emphasis on three factors. The first was the complete domination of Frankfort &

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<sup>142</sup> 82 S.W.2d 335 (Ky. 1935). This case involved an action based upon tort, rather than contract. Nevertheless, the Court tends to look at the same factors to determine liability. For a discussion of the applicability of tort cases, see note 129 *supra*.

<sup>143</sup> *Id.* at 338.

<sup>144</sup> Other factors were important in the Court's decision. For example, one of the stockholders and officers was connected with only one of the companies. The Court also emphasized that there was no ulterior purpose involved in the relationship between the two companies.

<sup>145</sup> 10 S.W.2d 1064 (Ky. 1927).

<sup>146</sup> *Id.*

Cincinnati by L & N. The Court stated that the general manager of Frankfort & Cincinnati "took no action involving any matter of policy without first consulting the officers of . . . [L & N]."<sup>147</sup> Second, there had been a commingling of the affairs of the two companies. Finally, some emphasis was placed on the fact that there was, in reality, only one economic unit. With these factors present, the Court upheld the liability of the parent company.

In summary, the Kentucky courts have recognized that the corporate entity should be disregarded in an appropriate instance. Further, while the evidence is somewhat thin, it appears that the Kentucky courts emphasize the same factors as do the courts of other jurisdictions. As a matter of attitude, however, the Kentucky Court of Appeals has been quite reluctant to disregard the corporate entity.

#### D. *Conclusions*

Where necessary to prevent unfairness, a court should disregard the corporate entity and hold the owner liable on the contractual obligation of the corporation. While most courts appear to accept this notion, some of the factors they typically select to establish the presence or absence of unfairness are ill-suited to that task. In defining which acts manifest unfairness, the contractual nature of the obligation must be considered. Accordingly, when a court is faced with the question of whether an owner should be held liable on a corporate obligation, the reasonable expectations of the plaintiff become critical. If the owner of the corporation has acted in a manner that defeats the reasonable expectation of the plaintiff, that act should be defined as unfair. If the problem of unfairness is framed in this manner, some of the previously discussed factors often relied upon by courts lose their significance.

##### 1. *Control*

In deciding whether to disregard the corporate entity, it is appropriate to limit liability to shareholders who had control over the corporation. It would be grossly unfair to hold a 1% shareholder of a large corporation personally liable on a corpo-

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<sup>147</sup> *Id.* at 1067.

rate obligation, if that shareholder had no control over the corporation. On the other hand, if a shareholder had enough control to have prevented the particular unfairness, it is appropriate to hold that person liable. This is consistent with the equitable nature of this doctrine.

This is not to say, however, that the exercise of control is an inherently unfair act. There is nothing "bad" about an owner of a corporation exercising complete and absolute control over his corporation. That right to control is an integral and legitimate part of owning a corporation. Accordingly, control should be defined as a limiting factor. It merely defines which owners of the corporation may bear personal liability for the unfair act.<sup>148</sup>

## 2. Undercapitalization

It is entirely sound to consider undercapitalization as an unfair act that necessitates the disregard of the corporate entity. One who signs a contract with a corporation should be entitled to assume that the corporation has a reasonable amount of capitalization from which he could recover in the event of a breach. Such an expectation is reasonable and justifiable.<sup>149</sup> Accordingly, if the corporation is undercapitalized, it is unfair to limit the plaintiff's recovery to the insufficient assets owned by the corporation.

This notion, however, must be reconciled with the right of a corporation, or any party to a contract, to limit those assets available to satisfy a contractual obligation. Unquestionably, a corporation has the right to extract an agreement from a creditor that the creditor will look only to the assets of the corporation, even if the corporation is undercapitalized. Such an agreement, however, should not be presumed, absent proof of a complete disclosure by the undercapitalized corporation.

The proper reconciliation of these concepts can be effected in the following manner. It normally should be presumed that

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<sup>148</sup> This notion appears implicit in some court language. *E.g.*, *Sirmons v. Arnold Lumber Co.*, 167 So. 2d 588 (Fla. 1964) ("The corporate veil will not be pierced when it is not shown that the corporation was used to mislead creditors or for fraudulent purposes; without more the mere fact that one or more individuals control the corporate activities is not sufficient to justify imposition of the corporate debt upon the shareholders . . . ." *Id.* at 589-90).

<sup>149</sup> *But see* *Hamilton*, *supra* note 49, at 986-88; 28 OHIO ST. L.J. 441, 458-59 (1967).



one contracting with a corporation has agreed to look only to the assets of the corporation for satisfaction of his claim. If, however, the complaining party can show that at the time the contract was signed, the corporation was undercapitalized, then the competing interest of preventing unfairness requires the normal rule to be suspended, and the party that contracted with the corporation should be permitted to disregard the corporate entity. There should be, however, one exception to this analysis. The corporate entity should not be disregarded, notwithstanding that there was undercapitalization, if the defendant can show that the precarious financial position of the corporation was disclosed and that the contracting party nonetheless agreed to look only to the assets of the corporation.

It should be noted that the above analysis measures inadequacy from the *date the obligation was incurred*, as opposed to the more traditional *date of incorporation*. Such an approach comports with the purpose for disregarding the corporate entity. Unfairness in such situations occurs because the capitalization is less than the amount the creditor bargained for and the security of his "investment" is accordingly impaired. The protection for creditors results from adequate capitalization at the time the obligation was incurred; capitalization at the initial incorporation is only incidentally related to this.

### 3. *Splitting the Economic Unit and Maintenance of Corporate Formalities*

It is difficult to understand why the splitting of a single economic unit should be a factor in a decision to disregard the corporate entity. Assuming there is adequate capitalization of the corporation and there is no misunderstanding as to which entity is liable under the contract, an individual or parent corporation should be allowed to fragment its business as it wishes. Unfairness occurs only when the subsidiary is either undercapitalized or when the party contracting with the subsidiary is misled into thinking that the entire economic unit is liable for the contract. In those two situations, however, it is not the splitting of the economic unit that generates unfairness. Both undercapitalization and misrepresentation engender unfairness independently of the split in the economic enterprise.

As with the splitting of the economic unit, it is difficult to

understand why the failure to maintain corporate formalities should be a factor in a decision to disregard the corporate entity. As stated earlier, commentators have correctly observed that no harm is caused a corporate creditor by failure to maintain the formalities of corporate existence.

#### 4. *Estoppel*

If the corporate entity is to be disregarded in order to insure fairness, it is rational to apply concepts of estoppel. It would be unfair to permit an owner of a corporation to make misrepresentations with impunity. Whether or not these misrepresentations would constitute common law deceit, this should be a factor considered by a court in determining whether to permit the owner of a corporation to hide behind the corporate veil. Applying an estoppel concept protects the reasonable expectations of one contracting with a corporation.

### V. CREDITOR'S SUIT TO ENFORCE A FIDUCIARY DUTY

In addition to the personal liability a shareholder may face if the corporate entity is disregarded, one who owns shares in a corporation may also incur personal liability, if while involved in the management of the corporation, the corporation is damaged as a result of his negligence.<sup>150</sup> Conceptually, this liability is distinct from any notion of disregarding the corporate entity in that it arises not from mere ownership of part of a corporation, but rather because of impropriety in a management function. Further, a breach of this duty is generally considered a wrong against the corporation. Accordingly, the cause of action must be enforced either by the corporation or derivatively by a shareholder in the right of the corporation.

If, however, a *corporate creditor* could sue the officers, directors or majority shareholders for harm caused by negligent management of the corporate affairs, this would be a significant protection for the creditors of a corporation and, as a practical matter, would expose the owners of corporations to more danger of personal liability. This is especially true of closely held corporations, where directors, officers and share-

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<sup>150</sup> For a discussion of the liability of corporate officers, directors and controlling shareholders, see N. LATTIN, *supra* note 61, at 272-334, 410-463.

holders are usually the same people; in such cases the owners of a corporation would lose their limited liability, at least to the extent that their mismanagement caused the corporation's inability to meet the debt owed the corporate creditor.

#### A. *Creditors' Rights in Non-Bankruptcy Situations*

In a number of cases, corporate creditors have argued that the management of the corporate debtor owes a fiduciary duty directly to its creditors, and, consequently, that those creditors have standing to enforce that right directly for their own benefit. In most of these cases corporate creditors have attempted to sue *officers* and *directors* for mismanagement that has rendered the corporation unable to pay its debts.<sup>151</sup> Although there is authority to the contrary, courts have usually been reluctant to impose this liability on corporate management. Ballantine has said that "[c]reditors have no direct right of action against directors or officers for mismanagement . . . by the better view."<sup>152</sup>

There is certainly substantial authority for this proposition, as exemplified by *Sutton v. Regan & Gee*.<sup>153</sup> In that case the corporate creditors sued the directors of the company, alleging that they should be liable, *inter alia*, because of their negligent failure to prevent the corporation's financial losses. The court held that the jury's finding of mismanagement would not support recovery by the creditors, because the primary injury from this negligence was to the corporation and consequently the right to recover was regarded as a corporate asset. The court stated that it was the "general rule that a creditor who sues solely on his own behalf cannot maintain a personal action against directors who, by negligent mismanagement of the corporation's affairs, have breached their duty to the corporation to the consequent injury of its creditors."<sup>154</sup>

Numerous other cases have also held that corporate creditors have no direct cause of action against the officers and

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<sup>151</sup> See generally 3 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS §§ 1180-84 (Perm. ed. 1965).

<sup>152</sup> H. BALLANTINE, *supra* note 88, at 184.

<sup>153</sup> 405 S.W.2d 828 (Tex. 1966).

<sup>154</sup> *Id.* at 835.

directors for mismanagement.<sup>155</sup> One reason courts have been reluctant to find a direct fiduciary duty is the absence of any legal relationship between the corporate creditor and the corporate management that would engender such a duty. Thus, courts have generally concluded that the management is not the trustee of the creditors.<sup>156</sup> Further, since the officer is the agent of the corporation and since under the law of agency a negligent agent is not directly liable to the creditors of his principal, the courts have yet another basis for denying the corporate creditor a direct action against the negligent director or officer.<sup>157</sup>

Although the above stated rule is widely accepted,<sup>158</sup> there is authority to the contrary.<sup>159</sup> Especially in older cases one sometimes encounters statements that:

any failure of a director to exercise diligence or good faith which results in loss to a stockholder or creditor entitles such stockholder or creditor to require the directors whose negligence have [*sic*] caused the loss to pay. In other words, the

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<sup>155</sup> *Nuclear Corp. of America v. Hale*, 355 F. Supp. 193 (N.D. Tex. 1973); *Skinner v. Hulsey*, 138 So. 769 (Fla. 1931) ("Directors are not liable to the creditors on the theory of their being fiduciaries." *Id.* at 773); *Confick v. Houston Civic Opera Ass'n*, 99 S.W.2d 382 (Tex. 1936) ("Directors are not personally liable to creditors for mismanagement, or for waste of assets except on proof of the commission of such fraud." *Id.* at 385); *Equitable Life & Cas. Ins. Co. v. Inland Printing Co.*, 484 P.2d 162 (Utah 1971); *Anderson v. Bundy*, 171 S.E. 501 (Va. 1933); *Wheeling Kitchen Equip. Co. v. R. & R. Sewing Centre, Inc.*, 179 S.E.2d 587 (W. Va. 1971); *Inter-Ocean Cas. Co. v. Lecony Smokeless Fuel Co.*, 17 S.E.2d 51 (W. Va. 1941). See the cases cited in R. BAKER & W. CARY, *CASES AND MATERIALS ON CORPORATIONS* 620 (3d ed. 1959).

<sup>156</sup> *Skinner v. Hulsey*, 138 So. 769 (Fla. 1931) ("It is difficult to perceive upon what principle a director of a corporation can be considered a trustee of its creditors." *Id.* at 769.) W. FLETCHER, *supra* note 148, §§ 1180-91.

<sup>157</sup> H. BALLANTINE, *supra* note 88, at 185-86; RESTATEMENT (SECOND) OF AGENCY § 352 (1958) states that "an agent is not liable for harm to a person other than his principal because of . . . [the agent's] failure adequately to perform his duties to his principal, unless physical harm results from reliance upon performance of the duties by the agent, or unless the agent has taken control of land or other tangible things."; *Whitfield v. Kern*, 192 A. 48, 55 (N.J. 1937) ("Directors . . . are no more accountable to the creditors for mismanagement of the corporate affairs than the agent of an individual would be to his principal's creditors.").

<sup>158</sup> W. CARY, *CASES AND MATERIALS ON CORPORATIONS* 865 (4th ed. 1969) ("This rule is usually applied to corporations and a creditor or class of creditors: only the corporation has a cause of action against the officer or director."); R. BAKER & W. CARY, *supra* note 155, at 620 (3d ed. 1959).

<sup>159</sup> Fletcher has stated that "[t]he weight of authority is in favor of permitting a recovery by creditors." W. FLETCHER, *supra* note 151, at § 1182; see the cases cited in R. BAKER & W. CARY, *supra* note 155, at 621.

director whose negligence causes loss is liable for such loss to stockholders and creditors.<sup>160</sup>

An example of the application of this rule is found in *Anthony v. Jeffress*,<sup>161</sup> a case in which a corporate creditor sued the corporation's directors for mismanagement of the corporation. The court found that the directors had been negligent in their running of the company, apparently because of their general inattention to corporate affairs.<sup>162</sup> Accordingly, the court reversed the lower court's judgment for defendant, holding that "[t]he law . . . holds [directors] . . . responsible for damages sustained by stockholders and creditors by reason of their negligence, fraud or deceit."<sup>163</sup>

In a more recent case, the United States Court of Appeals for the First Circuit, applying Massachusetts' law, indicated that corporate officers and directors may be directly liable to corporate creditors for mismanagement. In *W.H. Elliot & Sons Co. v. Gotthardt*,<sup>164</sup> a judgment creditor of King Company brought an action against King's officers and directors for a "violation of their fiduciary obligation to creditors of King Company."<sup>165</sup> Specifically, the judgment creditors alleged that, subsequent to their obtaining a judgment against King, the defendants permitted the diversion of corporate opportunities away from the company. The lower court had granted a summary judgment in favor of two of the defendants, but on appeal the decision was reversed with respect to one of the officers.<sup>166</sup> The court stated:

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<sup>160</sup> *Steinberg v. Blaine*, 17 S.W.2d 286, 288 (Ark. 1929). See also *Johnson v. Coleman*, 20 S.W.2d 186 (Ark. 1929). Both cases applied the rule to directors; both found the directors free from negligent conduct.

<sup>161</sup> 90 S.E. 414 (N.C. 1916).

<sup>162</sup> The harm to the plaintiffs resulted when Wooten, president of the company, willfully misrepresented the company's solvency to plaintiff, upon the faith of which plaintiff sold goods to the company. The claim against the directors was that their inattention permitted this to happen.

<sup>163</sup> *Anthony v. Jeffress*, 90 S.E. 414, 415 (N.C. 1916). In a recent case, however, the Supreme Court of North Carolina indicated that a creditor of a corporation could not sue the directors directly for mismanagement. The Court held that "[b]efore a creditor or stockholder may sue those guilty of mismanagement, he must allege a demand on the corporation, or its receiver if insolvent, to bring the suit and a refusal to do so." This was because the "claim of mismanagement exists in favor of the corporation." *Goodwin v. Whitener*, 138 S.E.2d 232, 233 (N.C. 1964).

<sup>164</sup> 305 F.2d 544 (1st Cir. 1962).

<sup>165</sup> *Id.* at 545.

<sup>166</sup> The summary judgment in favor of one defendant was affirmed because his position in the company was judged too minor to generate liability.

The Massachusetts cases with regard to the liability of corporate directors and officers to creditors for breach of their fiduciary obligations to creditors, or to the corporation itself, make it clear that the court has imposed liability . . . on corporate directors and major corporate officers.<sup>167</sup>

This doctrine found its furthest application in *Swinney v. Keebler Co.*,<sup>168</sup> where the Federal District Court for South Carolina indicated that a majority shareholder may owe a fiduciary duty to creditors. Although it has been recognized for some time that majority shareholders owe fiduciary duties to the corporation,<sup>169</sup> *Keebler* seems to have expanded the duty to protect creditors and, further, to have revitalized the notion of a fiduciary duty running from the management of a corporation to corporate creditors.<sup>170</sup>

In *Keebler*, Keebler Company, owner of all the stock of Meadors, Inc., sold all its Meadors stock to Atlantic Services, Inc. The plaintiffs, debenture holders of Meadors, brought an action "on behalf of themselves and other debenture holders," alleging that Keebler's sale of its Meadors stock to Atlantic violated Keebler's fiduciary duty to creditors because Atlantic subsequently looted the assets of Meadors<sup>171</sup> and because a rea-

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<sup>167</sup> *W. H. Elliott & Sons Co. v. Gotthardt*, 305 F.2d 544, 545 (1st Cir. 1962).

<sup>168</sup> 329 F. Supp. 216 (D.S.C. 1971).

<sup>169</sup> See H. HENN, *supra* note 126, at 475 ("Controlling shareholders, especially when approving extraordinary corporate matters requiring shareholder approval, are usually subjected to fiduciary duties.").

<sup>170</sup> Although the case was reversed on appeal, 480 F.2d 573 (4th Cir. 1973), the circuit court opinion was based on a finding that there was no unreasonable conduct on the part of Keebler. The court stated that "if the sellers of control are in a position to foresee the likelihood of fraud on the corporation, including its creditors . . . , or on the remaining stockholders, at the hands of the transferee, their fiduciary duty imposes a positive duty to investigate. . . ." *Id.* at 578.

<sup>171</sup> The looting took the form of Atlantic's paying for the purchase of the Meadors stock (\$230,000) with cash from Meadors' assets, substituting for the cash an account payable from Atlantic to Meadors for the amount of cash used. Subsequently, Atlantic sold Meadors to Flora Mir Distributing Company (a company with negligible assets) for \$352,000. Again, the purchasing company (this time Flora Mir) utilized the assets of Meadors to finance the purchase. As a result of the second transaction, Atlantic was able to pay its \$230,000 owed to Meadors, with an additional \$122,000 left as profit. For the assets used by Flora Mir to pay Atlantic, an account payable from Flora Mir was entered on the books of Meadors. At the end of these transactions, "Keebler had \$230,000; Atlantic Services had \$122,000 net and Meadors to whom the plaintiff creditors looked had a \$352,000 account receivable from a corporation with no assets." *Swinney v. Keebler Co.*, 329 F. Supp. 216, 219 (D.S.C. 1971).

sonable investigation of Atlantic by Keebler would have disclosed Atlantic as a corporate raider. In summarizing the plaintiffs' argument the court stated:

[p]laintiffs place their principal reliance upon the theory that the owners of a controlling interest in a corporation owe a fiduciary duty to the corporation's creditors as well as stockholders . . . . No matter that the controlling shareholder may have [the power to sell his control] . . . , it is subject to the equitable limitation that it may not be used for the benefit of the fiduciary at the expense of the "community of interests in the corporation — creditors as well as stockholders."<sup>172</sup>

The court held that in failing to reasonably investigate the purchaser of the Meadors stock, Keebler breached this fiduciary duty. The court further stated that, although "it is not clear whether as a practical or legal matter that liability is to Meadors or the debenture holders . . . , the judgment, when the amount of damages has been determined, will take such form as is necessary to make the debenture holders whole."<sup>173</sup>

While *Keebler* indicates that the corporate creditor may

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<sup>172</sup> *Id.* at 222 (citation omitted).

<sup>173</sup> *Id.* at 225. In reaching its decision, the court in *Keebler* apparently relied on language from *Pepper v. Litton*, 308 U.S. 295 (1939). In *Pepper* the Supreme Court disallowed a claim by a judgment creditor against a bankrupt corporation. The reason for disallowing that claim was that the claimant, who was also the controlling and dominant shareholder of the bankrupt corporation, had utilized a "planned and fraudulent scheme" to attain an unwarranted claim to the assets of the bankrupt corporation. The Supreme Court made it clear, however, that a breach of a fiduciary duty (as opposed to actual fraud) by a majority shareholder could also result in his claim being disallowed or subordinated to other creditors. The Court stated:

While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation — creditors as well as stockholders. *Id.* at 307.

*Pepper v. Litton* does not hold that a corporate creditor can sue a majority shareholder for a breach of fiduciary duty. Rather, it holds that claims of a majority shareholder against a bankrupt corporation will be disallowed if those claims have been unfairly obtained. The court did indicate, however, that a violation of a majority shareholder's fiduciary duty to the corporation will generate liability that can be enforced by the trustee. This would result in benefit to the creditors, as the bankrupt estate would be increased by the amount of any judgment received. See the discussion at part V of this article. Absent bankruptcy, however, the Court stated that "[n]ormally . . . [a] fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action . . . ." *Pepper v. Litton*, 308 U.S. at 307.

have a remedy against a majority shareholder for the latter's negligent act, one conceptual problem remains — whether the creditor can enforce the action directly in his own right or whether he is required to enforce it in a derivative action. *Keebler* is equivocal on this point. There, the action was brought by “holders of subordinated debentures of Meadors . . . on behalf of themselves and other debenture holders . . . .”<sup>174</sup> At one point, however, the court stated the issue in terms of whether the defendants breached a fiduciary duty owed to Meadors.<sup>175</sup>

Normally the breach of a fiduciary duty by a corporate officer, director, or majority shareholder generates liability that may be enforced by the corporation.<sup>176</sup> Since harm to the corporation is also harm to its shareholders, a procedure has developed by which a shareholder can enforce the right of the corporation against the officer, director or majority shareholder.<sup>177</sup> The prosecution of this derivative right, however, is subject to certain requirements. One of these is that the plaintiff must be a shareholder of the corporation.<sup>178</sup> Accordingly, creditors are generally thought to have no right to sue derivatively “in the shoes of” the corporation.<sup>179</sup> The court in *Keebler*, however, clearly indicated that, at least in one jurisdiction, the corporate creditor has a remedy. Further, the court indicated that if liability does not run directly to the creditors then it at least runs to the corporation, and, apparently, can be enforced as a derivative right by the creditors.

There are other cases that likewise seem to support the right of a corporate creditor to bring a derivative action. In *Anderson v. Bundy*,<sup>180</sup> depositors of an insolvent bank brought

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<sup>174</sup> *Swinney v. Keebler Co.*, 329 F. Supp. 216 (D.S.C. 1971).

<sup>175</sup> *Id.* at 218.

<sup>176</sup> N. LATTIN, *supra* note 61, at 410.

<sup>177</sup> For a discussion of derivative suits, see H. BALLANTINE, *supra* note 88, at 333-74.

<sup>178</sup> While it is generally agreed that the plaintiff must have been a shareholder at the time of the commencement of the suit, there is a split as to the additional requirement that the plaintiff also have been a shareholder at the time of the wrong. H. HENN, *supra* note 129, at 761-69; Dyrstra, *Revival of the Derivative Suit*, 116 U. PA. L. REV. 74, 94-97 (1967).

<sup>179</sup> H. BALLANTINE, *supra* note 88, at 351; 13 W. FLETCHER, *supra* note 151, at § 5972.2.

<sup>180</sup> 171 S.E. 501 (Va. 1933).



an action against the directors of the bank alleging that the bank's failure had been caused by the negligence of the directors. After holding that "directors must exercise ordinary care and prudence in the protection of their depositors"<sup>181</sup> and that the directors had failed to exercise such care, the court discussed the depositors' remedy:

It is clearly the law, at least in most jurisdictions, and certainly in Virginia, that no direct action lies to a creditor of a corporation against its directors who are its agents . . . for improper performance or failure in performance of their duties. This is a right belonging to the corporation only . . . . The creditors must sue, not for any direct right of action in them but in the right of the corporation, after the corporation, or its proper representatives have refused to act.<sup>182</sup>

In *Goodwin v. Whitener*<sup>183</sup> the North Carolina Supreme Court joined the ranks of the courts that allow a creditor to prosecute a derivative action.<sup>184</sup> The plaintiff had a judgment against a corporation which he was unable to satisfy. An action was brought against the directors of the corporation, alleging that the insolvency of the corporation was caused by the "reckless, extravagant, and fraudulent schemes and devices" of the directors. The court held that the plaintiff had not stated a cause of action, apparently because he had not followed the procedural requirements necessary for a derivative action. What is significant, however, is the court's clear implication that a creditor can sue derivatively in the right of the corporation. The court stated:

The duties which have been breached by this mismanagement are duties primarily to the corporation. Before a creditor or stockholder may sue those guilty of mismanagement, he must allege a demand on the corporation, or its receiver if insolvent, to bring the suit and a refusal to do so. Even then the corporation must be made a party defendant; and any recovery must be held for the benefit of the corporation.<sup>185</sup>

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<sup>181</sup> *Id.* at 506.

<sup>182</sup> *Id.* at 508.

<sup>183</sup> 138 S.E.2d 232 (N.C. 1964).

<sup>184</sup> *Accord*, *Ford Motor Credit Co. v. Minges*, 473 F.2d 918 (4th Cir. 1973) (applying North Carolina law); *Underwood v. Stafford*, 155 S.E.2d 211 (N.C. 1967).

<sup>185</sup> *Goodwin v. Whitener*, 318 S.E.2d 232, 233 (N.C. 1964). The requirements explained are standard to the prosecution of a derivative right by shareholders. See H.

In Kentucky there is at least some language supporting the right of corporate creditors to sue officers and directors directly for mismanagement. Generally, however, these cases are old and the language is dictum.<sup>186</sup> *Caldwell v. Ryan*<sup>187</sup> is an example. In that case Caldwell, a director of an insolvent bank, had agreed with the shareholders of the bank to pay the bank's creditors 75% of amount due them from the bank.<sup>188</sup> In return, the shareholders had agreed not to institute a suit against Caldwell for his mismanagement of the bank. Ryan, a creditor of the bank, brought a suit against Caldwell, attempting to enforce the terms of the agreement as third party beneficiary in order to recover at least part of the debt owed him by the insolvent bank. On contract principles the Court decided that Ryan could enforce the contract, holding that the agreement between Caldwell and the shareholders "was executed for the benefit of creditors and it was based on a sufficient consideration."<sup>189</sup> Significantly, however, the Court pointed out that Ryan had an alternate ground for recovery: "The creditors of the bank . . . had the right to seek indemnity from the directors if they [the directors] were guilty of negligence in the management of the bank and this negligence resulted in loss to them [the creditors]."<sup>190</sup>

In an earlier case, however, the Kentucky Court had stated that the right of a creditor to sue for mismanagement was of a derivative nature. In *Savings Bank of Louisville's Assignee v. Caperton*,<sup>191</sup> a creditor (depositor) of the bank brought an action against the directors of the insolvent bank for the recovery of money deposited in the bank. The basis of the action was that the directors had been negligent in their supervision of a

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HENN, *supra* note 129, at 755-81. There are other cases indicating that a creditor may be able to obtain relief by a derivative suit. *E.g.*, *Browne v. Hammett*, 131 S.E. 612 (S.C. 1926) ("The rule regulating action by the creditors in the right of the corporation is the same as that applied to actions by stockholders." *Id.* at 615.)

<sup>186</sup> See *Brannin v. Loving*, 82 Ky. 370 (1884); *United Soc'y of Shakers v. Underwood*, 72 Ky. 609 (1873).

<sup>187</sup> 190 S.W. 1078 (Ky. 1917).

<sup>188</sup> This was beneficial to shareholders because, under the existing statutes, they were personally liable for an amount equal to the par value of their stock. Ky. Stat. §§ 547, 547a (1936) (repealed).

<sup>189</sup> *Caldwell v. Ryan*, 190 S.W. 1078, 1080 (Ky. 1917).

<sup>190</sup> *Id.*

<sup>191</sup> 8 S.W. 885 (Ky. 1888).

cashier, who had embezzled \$118,000, and that the assignee for all the assets of the bank had refused to sue. While the Court ultimately held that the directors had breached no duty, finding that they had acted with reasonable care and due diligence, the Court first discussed the proper procedure to be followed by creditors in asserting their rights against negligent officers and directors. Noting that normally the creditors of a corporation have no direct cause of action against the directors, Justice Pryor, writing for the majority, stated that "[d]irectors are under no personal liability to the creditors of a bank by reason of a neglect of duty. They are the agents of the corporation . . . ." <sup>192</sup> The Court indicated, however, that it would be unwilling to leave the creditors who were harmed by directors' negligence without a remedy. Thus, while the Court decided that such a suit by creditors would be, "at last, . . . the bank suing the directors . . . for a neglect of duty," it apparently affirmed the right of creditors to enforce that right, at least in cases where there was a "refusal of the assignee to sue." <sup>193</sup> It seems, therefore, the Court was allowing creditors to enforce a derivative right.

Because of the absence of recent Kentucky cases, it would be dangerous to predict success for a creditor who attempts to sue the officials of a Kentucky corporation for mismanagement. Such a result is sound, however, and it is submitted that Kentucky should adopt a rule that permits a creditor such a right. Indeed even absent precedent, there are compelling reasons for extending such protection to creditors, the most obvious of which is to insure fairness. <sup>194</sup> By extending credit to the corporation, creditors have acquired an interest in the corporation. They have invested assets or money in the corporation and, accordingly, expect a return in the form of repayment. If the corporation becomes unable to meet the repayment obligation because of the negligent mismanagement of the corporate

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<sup>192</sup> *Id.* at 890.

<sup>193</sup> *Id.*

<sup>194</sup> As indicated earlier, courts by disregarding the corporate entity have protected creditors from some types of unfairness at the hands of corporate shareholders. See the discussion *supra* at part IV of this article. Thus, such factors as undercapitalization have led courts to hold shareholders individually liable to corporate creditors. It would seem consistent to extend the protection to cover harm caused the creditor by management's negligence in running the affairs of the corporation.

affairs, creditors should have some recourse. Otherwise there is an unfair apportionment of loss, unfair because the creditors must bear a loss created by the negligence of another, over whom they had no control. Courts should always be reluctant, when deciding which party should bear a loss, to require the innocent party to bear the economic loss caused by the negligence of another. Absent a strong policy reason to the contrary, fairness demands the negligent party be held liable. In this instance, that party would be the corporate management, which caused the inability of the corporation to meet its obligations.

The unfairness to creditors of a denial of relief becomes even more apparent when one considers that shareholders are protected from mismanagement by the right to sue derivatively. Creditors, on the other hand, who have essentially the same investment in and expectation from the corporation, may be denied any relief. Both creditors and shareholders have invested assets in the corporation; both expect a return. Disparate treatment is indefensible.<sup>195</sup>

If a court in Kentucky were inclined to permit creditors the right to sue management in a derivative action, additional considerations would become important. The first of these is that there is an apparent conflict with Kentucky Revised Statutes (hereinafter KRS) § 271A.245. That section of the Kentucky Business Corporation Act can be read as limiting the use of the

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<sup>195</sup> The assertion in this paper that shareholders and creditors have essentially the same interest in a corporation will probably generate disagreement from some. I am well aware that the contractual agreements between the corporation and shareholders differ significantly from the agreements between the corporation and its creditors. For example, order of payment on liquidation is different; interest rates and dividends may differ; creditors may have certain protective provisions not enjoyed by shareholders. These factors notwithstanding the essence of the shareholder's relationship to the corporation is the same as the creditor's relationship to the corporation. Both have invested something of value in the corporation. The shareholder usually invests money. The creditor, however, may "invest" money (for example, a bank loan), goods (for example, selling goods to a corporation on credit) or services (for example, a plumber who does work for a corporation on credit). In any case, value has been invested. Further, both shareholders and creditors expect a return on their investment. The amount of the return expected differs, but there is still the basic expectation that the corporation will pay out something of value. Finally, the expected return in both instances is dependent on the corporation's management. Therefore, I would contend that the creditor is essentially in the same situation as the shareholder.

derivative suit to shareholders of the corporation.<sup>196</sup> It is suggested, however, that permitting a creditor to prosecute a derivative action is not foreclosed by the language of the Kentucky Business Corporation Act. A close examination of KRS § 271A.245 reveals nothing that indicates the drafters gave any consideration to the right of a *creditor* to institute a derivative suit. Rather, the section appears to be merely an attempt to dictate procedure with respect to a particular right: the right of a *shareholder* to sue derivatively. The section states: "No derivative action shall be brought . . . by a person claiming ownership of shares of a corporation . . . unless . . ."<sup>197</sup> Thus the section intends only to control shareholders' derivative suits; not to prohibit derivative suits by non-shareholders.

The origin and development of the derivative suit suggest its appropriateness as a mechanism to protect creditors. In his article on the history of the derivative action, Professor Prunty asserted that "the origin of the derivative suit lies in judicial recognition of a new wrong or maladjustment for which pre-existing legal procedures proved more or less inadequate."<sup>198</sup> Since a "maladjustment" results from the denial of relief to a corporate creditor who has been injured by mismanagement,

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<sup>196</sup> KY. REV. STAT. § 271A.245 (Supp. 1972) [hereinafter cited as KRS]. This section states:

No derivative action shall be brought in this state in the right of a domestic or foreign corporation by a person claiming ownership of shares of the corporation or voting trust certificates therefor unless the plaintiff was an owner of shares or of voting trust certificates therefor at the time of the transaction of which he complains, or his shares or voting trust certificates thereafter devolved upon him by operation of law from a person who owned them at such time. The complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders, and the reasons for his failure to obtain the action or for not making the effort. No such derivative action shall be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders in such manner as the court directs.

This section is similar to the federal rule. FED. R. CIV. P. 23.1. For a discussion of this federal rule, see 3B J. MOORE, FEDERAL PRACTICE ¶¶ 23.1.01 - .25 (2d ed. 1974).

<sup>197</sup> KRS § 271A.245 (Supp. 1972).

<sup>198</sup> Prunty, *The Shareholders Derivative Suit: Notes on its Derivation*, 32 N.Y.U.L. REV. 980, 992 (1957). At another point Prunty states that the derivative suit "was born and nurtured as a corrective for managerial abuse in economic units which by their nature deprived some participants of an effective voice in their administration." *Id.* at 994.

the derivative suit would seem an appropriate procedure to remedy this situation. It would be merely a logical extension of a procedure designed to protect the parties harmed by corporate mismanagement.<sup>199</sup>

Not only do the history and purpose of the derivative suit support its use to protect creditors, but in addition the rules governing derivative suits provide protection to creditors. Specifically, the rule has developed that a pro rata recovery by a shareholder in a derivative suit is not permitted, except in exceptional circumstances.<sup>200</sup> Rather, the full corporate loss must be awarded to, and the recovery is in favor of, the corporation.<sup>201</sup> The purpose for this rule was well stated by the court in *Liken v. Shaffer*:

One of the reasons why courts of equity have not allowed direct proportionate recoveries in stockholder's derivative suits, has been that the recovery is an asset of the corporation, and its creditors have first claim upon it; and that to award such recovery direct to the stockholders leaving any creditors unpaid, would be fraudulent as to them.<sup>202</sup>

It seems quite anomalous to prohibit a pro rata recovery by shareholder because of a need to protect creditors, while prohibiting creditors from instituting a derivative suit in order to protect themselves.

In summary, creditors, either by a suit in their own right or by a suit in the right of the corporation, should be permitted a right of action to remedy harm caused them by management's negligence or breach of fiduciary duties. Such a right has some support from case law. Further, there is support, both in the history and purpose of derivative suits, for permitting such recovery derivatively. Finally, and of utmost importance, such recovery, whether based on a direct fiduciary duty or on a derivative right, is essential to fair treatment of corporate creditors.

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<sup>199</sup> Since the derivative suit was originally a court developed procedure, a court would seem an appropriate body to expand the doctrine. See H. BALLANTINE, *supra* note 88, at § 145; Hornstein, *The Shareholder's Derivative Suit in the United States*, 1957 J. Bus. L. 282.

<sup>200</sup> See H. HENN, *supra* note 129, at § 373.

<sup>201</sup> See W. FLETCHER, *supra* note 151, at § 6028; N. LATTIN, *supra* note 61, at § 104.

<sup>202</sup> *Liken v. Shaffer*, 64 F. Supp. 432, 441 (N.D. Iowa 1946). *Accord*, *LaHue v. Keystone Inv. Co.*, 496 P.2d 343 (Wash. 1972).

## B. *Creditors' Rights in Bankruptcy*

There is one final procedure by which a corporate creditor can obtain relief for harm caused him by an officer's, director's or majority shareholder's mismanagement. This procedure is found in the Bankruptcy Act.<sup>203</sup> Where the mismanagement has created the proper conditions, the Bankruptcy Act gives the creditor important recovery rights. Under section 101(a) of the Bankruptcy Act, the trustee becomes vested with title to enumerated assets of the bankrupt.<sup>204</sup> Specifically vested in the trustee by virtue of section 101(a)(5) is "property, including rights of action, which prior to the filing of the petition [the bankrupt] could by any means have transferred or which might have been levied upon and sold under judicial process . . . ."<sup>205</sup> If, therefore, the "rights of action" include the right to sue officers, directors and majority shareholders for breaches of fiduciary duty, the creditors of the bankrupt corporation will be the beneficiaries of this provision, and the officers, directors or majority shareholders will indirectly be liable to corporate creditors.

Before the creditors can make use of the trustee's ability to sue in their behalf, though, a petition in bankruptcy must be filed for the corporation. It is possible that the corporation might voluntarily file its own petition in bankruptcy; but more importantly, the creditors can, under proper circumstances, initiate the proceedings themselves. Under the provisions of the Bankruptcy Act, a creditor can force a business corporation<sup>206</sup> into bankruptcy if the corporation owes debts of \$1,000 or more, if the creditor is able to get the prescribed number of qualified creditors to join his petition<sup>207</sup> and if the corporation

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<sup>203</sup> 11 U.S.C. §§ 1-1255 (1970).

<sup>204</sup> 11 U.S.C. § 110(a) (1970).

<sup>205</sup> 11 U.S.C. § 110(a) (5) (1970). Subsection (6) also vests in the trustee "rights of action arising upon contracts, or usury, or on the unlawful taking or detention of or injury to his property . . . ." 11 U.S.C. § 110(a)(6) (1970).

<sup>206</sup> 11 U.S.C. § 22(b) (1970).

<sup>207</sup> 11 U.S.C. § 95(b) (1970). This section states "Three or more creditors who have provable claims . . . amounting in the aggregate to \$500 in excess of the value of any securities held by them, or if all of the creditors of the person are less than twelve in number, then one or more of the creditors whose claim or claims equal that amount may file . . . ."

has committed an act of bankruptcy.<sup>208</sup> With respect to the latter requirement, this can occur if the corporation, while insolvent, allows a lien obtained "through legal proceedings" to remain undischarged for 30 days.<sup>209</sup> Thus, a creditor often can force a corporation into bankruptcy by reducing his debt to a judgment and obtaining a judicial lien on the property of the corporation. Thereafter three other creditors may join and successfully petition for the corporation to be judged bankrupt.<sup>210</sup> In Kentucky it would appear that once the execution on the judgment is delivered to the sheriff, a lien has attached to the property of the debtor,<sup>211</sup> and the failure to vacate that lien within the prescribed time will create an act of bankruptcy as against an insolvent debtor.

Once the corporation is adjudicated bankrupt, a trustee is selected either by the creditors of the bankrupt or by the referee.<sup>212</sup> It is his primary duty to "conserve and advance the interests of the estate entrusted to him. . . ."<sup>213</sup> Simply stated, the trustee is charged with the duty to collect the assets of the bankrupt and to make distributions from those assets to the appropriate parties.<sup>214</sup> With the corporation properly into bankruptcy proceedings, either voluntarily or involuntarily, the trustee can sue and recover against corporate officers, directors and majority shareholders for violation of their fiduciary duties resulting in injury to the corporation.<sup>215</sup> Further, if

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<sup>208</sup> 11 U.S.C. § 21(a) (1970). There are other "requirements" which must be met before a creditor can successfully force a debtor into involuntary bankruptcy. For example, a debtor-corporation must be a corporation that can be forced into involuntary bankruptcy. 11 U.S.C. § 21(b) (1970).

<sup>209</sup> 11 U.S.C. § 21(a)(3) (1970).

<sup>210</sup> It is important to note that the Bankruptcy Rules preclude the creditor who participated in the act of bankruptcy (in this example the creditor obtaining the lien that remains unsatisfied) from being one of the three petitioners necessary to force the corporation into involuntary bankruptcy under 11 U.S.C. § 95(b) (1970). See also Bankruptcy Rules and Official Forms 104(b) (U.S.C.A. 1973).

<sup>211</sup> KRS § 426.120 (1970).

<sup>212</sup> 11 U.S.C. § 72 (1970).

<sup>213</sup> 2 COLLIER, *supra* note 47, at 1743.

<sup>214</sup> See *Maryland Cas. Co. v. Central Trust Co.*, 79 N.E.2d 253, 256 (N.Y. 1948). One court has said that the trustee's "sole care should be to make the most out of the estate, and that primarily in the interest of the creditors." *In re Wresley Co.*, 133 F. 388, 390 (7th Cir. 1904).

<sup>215</sup> See, e.g., *Dwyer v. Tracey*, 118 F. Supp. 289 (N.D. Ill. 1954). See also the cases cited at C. NADLER, *THE LAW OF BANKRUPTCY* § 281 n.129 (2d ed. 1965).



the trustee refuses to prosecute the cause of action, the creditors can petition the bankruptcy court to compel the trustee to take such action.<sup>216</sup> An excellent exposition of this right to sue, as well as a discussion of the posture of the trustee, is found in *Gochenour v. Cleveland Terminals Building Co.*<sup>217</sup> where the court stated:

The right of action of a corporation to recover damages because of the misconduct and neglect of duty of a corporate officer passes to the trustee of a bankrupt corporation. If this duty has been so violated as . . . to result in the impairment of assets, of loss of property, or an officer, by misconduct, makes a profit for himself at the expense of the corporation, he may be compelled to make full restitution . . . and as the corporation could have maintained a suit for reimbursement from its officers for misconduct, the right of such an action was an asset of the company and passed to the trustee in bankruptcy.

The object of the Bankruptcy Act is to benefit creditors by making all the pecuniary means and property of the bankrupt available to their payment and in furtherance of this object, there passes to the trustee, not only what in strictness may be called the property of the bankrupt, but also those rights of action to which he was entitled for the purpose of recovering real or personal property, or damages respecting that which has been unlawfully diminished in value, withheld or taken from him.<sup>218</sup>

The impact of this on the concept of limited liability is apparent. A creditor unable to extract payment from a corporation can generally force the debtor-corporation into bankruptcy. The trustee then has the duty to sue any officer, director or majority shareholder whose negligence has harmed the corporation. Therefore, to the extent that the corporation's inability to pay is due to the negligence or the breach of fiduciary duty of an officer, director or majority shareholder, the liability of that person is not limited merely to his investment in the corporation. Rather, his personal assets are exposed to the extent that his mismanagement caused harm to the corporation.

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<sup>216</sup> *Gochenour v. Cleveland Terminals Bldg. Co.*, 118 F.2d 89 (6th Cir. 1941); *Gochenour v. George and Francis Ball Foundation*, 35 F. Supp. 508 (S.D. Ind. 1940).

<sup>217</sup> 118 F.2d 89 (6th Cir. 1941).

<sup>218</sup> *Id.* at 93.

## VI. CONCLUSION

In determining liability under a contract, basic principles require the court to consider the expectations of the parties involved. Accordingly, when deciding whether a corporation's owner should be liable for a corporate obligation, the reasonable expectations of the party contracting with the corporation are critical. By disregarding the corporate entity in appropriate instances and enforcing fiduciary duties in favor of creditors, courts can protect the reasonable expectation of the party contracting with the corporation and thereby insure fairness.

As stated earlier, one who contracts with a corporation reasonably expects that the corporation will be adequately capitalized and that representations made to him are truthful. If these reasonable expectations are defeated by the owners of the corporation, the owners should be denied the protection of limited liability. This is the proper use of the concept of disregarding the corporate entity.

After the obligation is incurred, an owner of a corporation should be denied limited liability if that owner's negligence or unfairness has caused the corporation's inability to meet its obligation. This proposition is supported by two rationales. The first is that one contracting with a corporation has a reasonable expectation that the corporation will be run in a fair and non-negligent fashion. If this expectation is not met, limited liability should be denied. The other justification, somewhat related to the first, is based on the need to fairly apportion losses. If a creditor fails to receive his payment because of the negligence of the owner (or director or officer) of a corporation, the court is required to determine who is to bear that loss. If the corporate entity is respected, it will be borne by the creditor; if the corporate entity is disregarded, it will be borne by the negligent owner. Absent a strong policy reason to the contrary, the more blameworthy party — the negligent owner — should bear the loss. This fair apportionment of loss can be effected in almost every case by enforcing a fiduciary duty in favor of creditors.

